

Reining in Opportunity Fund Fees

*It is time for real estate
opportunity fund investors
to bring fee structures into
alignment with the returns
being projected and delivered.*

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REAL ESTATE OPPORTUNITY funds became prominent in the early 1990s, as investors sought to participate in the recovery of the real estate markets and take advantage of the lack of available capital. These early funds promised minimum net returns of 18 percent to 20 percent and often delivered twice that. General partners (GPs) were handsomely rewarded for that performance with a fund management fee of 1.5 percent on committed capital, plus 20 percent of total profits. Driven by this success, opportunity funds and their GPs have become a permanent fixture. Although property markets corrected, capital seeking real estate has become over-abundant and the ease of achieving net returns in excess of 20

percent has vanished. The result is a disconnect between compensation and investment performance.

Opportunity fund structures typically fall within a range of terms and conditions, with variations resulting from a variety of factors, including prior performance/history, size of program, investment strategy, and founding limited partners (LPs). Generally, there is a preferred return to investors of 9 percent to 11 percent, a catch-up to the GP until the GP receives 20 percent of total profits (GP carry), with the catch-up typically ranging from 60/40 (GP/LP) to 40/60 (GP/LP). Fund management fees are typically 150 basis points, 125 basis points for commitments of at least \$75 million, and 100 basis points for commitments over \$100 million. The opportunity fund GP invests capital over a three-to-four-year period, is paid his fund management fee on committed capital, and may be reimbursed for a variety of costs such as accounting department overhead, travel, and dead deal pursuit costs that a manager of core assets would not receive. There are even several funds that have acquisition fees of 50 to 100 basis points on gross acquisition price. Thus, if the investment is 75 percent levered, the fee is 400 basis points on invested equity. Funds also vary by the degree to which there is a clawback against over-distributions to the GP, to ensure distributions to investors according to the basic structure.

THE PROBLEM

Depending on the pattern of cash flows, for a fund with a 10 percent preferred return and a 60/40 catch-up, the GP is likely caught-up to 20 percent of total profits at a net return to investors of 12.5 percent, corresponding to a gross return of 16.5 percent. This net return, on an unlevered basis, simply does not warrant this level—400 basis points—of compensation to the GP. No GP should be rewarded merely for utilizing leverage. Put another way, an investor can readily achieve a 12.5 percent net return with less risk by leveraging a core investment and without paying 400 to 450 basis points on equity in fees. An unlevered gross return of 7.35 percent that is levered 67 percent achieves a gross return of 10 percent—the standard preferred return over which the GP receives a disproportionate share of distributions.

Real estate opportunity funds based their structures on the private equity funds of the early 1990s. Investors didn't mind paying 20 percent of total profits for returns that on a net basis exceeded 20 percent to the investor. Few were bothered by the structure until the funds failed to deliver net 20 percent IRR returns, or worse, failed to deliver returns that exceeded unlevered core real estate returns. The problem lies with a structure that compensates the GP extremely well for having performed modestly.

**RISK, RETURN,
AND STRATEGY**

A cornerstone of the private equity fund philosophy is that GP compensation should reflect performance, and the interests of GPs and LPs should be aligned via the compensation arrangement. Managers should be rewarded with outsized fees only for exceptional performance. During the period between 1996 and 2000, a fund that bought the NCREIF Index and levered it 75 percent would have achieved a gross return of 29.5 percent. Managers should not be rewarded with outsized fees merely for utilizing leverage.

The fees associated with a core open-ended fund are approximately 70 basis points on invested gross value. While it is rare for a pension fund to lever core more than 50 percent loan-to-value (LTV), the effect on fees of leveraging up to 70 percent

(at a 5.0 percent interest), expressed as basis points on invested equity, is displayed in Table I.

The 210 basis points fee load on levered core at 66.6 percent LTV is the minimum fee that should be paid to an opportunity fund GP who has used a similar amount of leverage. Additionally, the approximately 15 percent net return sets the threshold over which opportunity fund GPs should be compensated for performance.

Investors have a wide range of alternatives in allocating their real estate capital along the spectrum of risk and reward. Strategies are generally categorized as: core; levered core; value-added; and opportunity. Net returns from an unlevered core strategy are generally 8.8 percent. Adding 15 percent to 50 percent leverage yields net returns of 9.4 percent to 12.9 percent. Net returns from a value-added strategy with 60 percent to 67 percent leverage should be at least 15.0 percent to 17.5 percent. The net returns from an opportunity fund that has performed should deliver 20 percent at a minimum. The fees associated with a core open-ended fund are approximately 70 basis points on invested gross. Adding leverage and assuming additional risk from a repositioning strategy results in approximately 200 to 350 basis points of fees on equity for value-added investments. The fees for an opportunity fund with net returns of 18 percent to 22 per-

Table I: Gross versus Net Return on Different LTVs

Core Strategy (6-Year Hold)			
LTV (%)	BPs on Equity	Gross IRR (%)	Net IRR (%)
0	70	9.50	8.80
30	100	11.33	10.33
35	108	11.79	10.71
40	117	12.32	11.15
45	127	12.95	11.67
50	140	13.69	12.29
55	156	14.59	13.03
60	175	15.69	13.94
65	200	17.09	15.09
66.6	210	17.62	15.52
70	233	18.91	16.58
75	280	21.40	18.60

Table II: Investment Strategy Summary

	Core	Leveraged Core	Value-Added	Opportunity
LTV (%)	0	15.0–50.0	60.0–67.0	67.0
Unlevered Gross (%)	9.5	9.5–10.0	10.5–11.0	12.0–13.0–14.0
Levered Gross Return (%)	NA	10.3–14.3	17.7–21.0	22.8–24.9–27.1
Cost to Invest (bps)	70	85–140	200–350	480–495–510
Net Return (%)	8.8	9.4–12.9	15.0–17.5	18.0–20.0–2 2.0

cent results in fees of approximately 450 to 500 basis points.

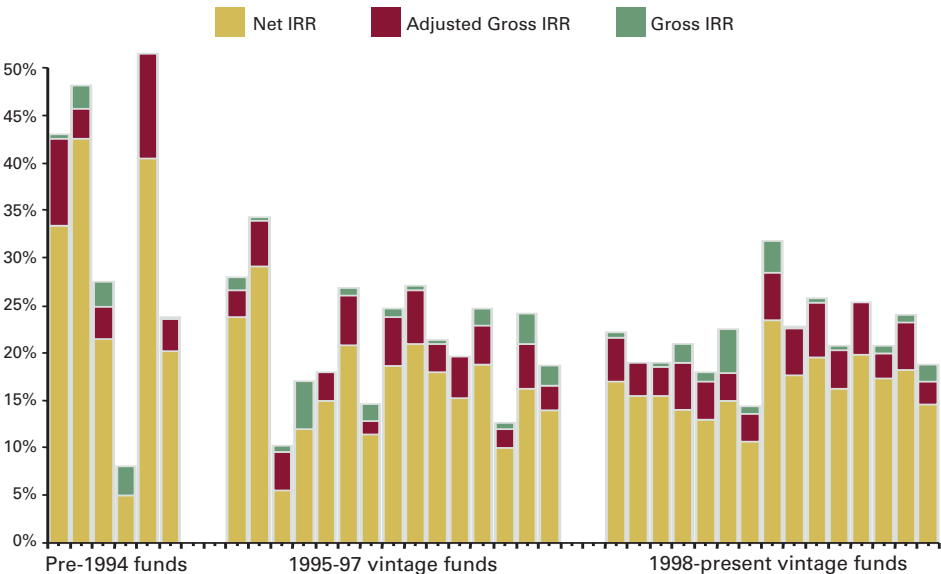
WHAT IS PERFORMANCE?

To understand how opportunity funds are expected to perform on a net basis and the associated level of fees and expenses, it was necessary to define various levels of returns. A large number of funds (\$28.2

billion in invested capital) was surveyed. IRRs since inception were calculated by utilizing current fair market value (FMV) as the reversion, and as projected through liquidation. Unfortunately the relevance of the FMV returns is undermined by the lack of consistent valuation policies across funds, with many funds valuing investments at cost until they are realized.

Both sets of returns were based on gross, adjusted gross, and net returns.

Figure 1: Fund Returns



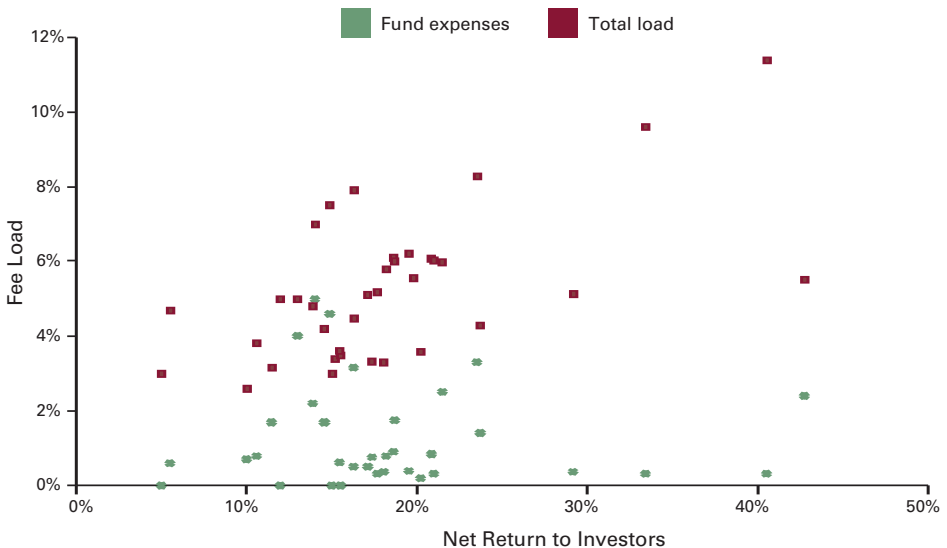
Gross was defined as the fund's investment level IRR in local currency net of debt. Adjusted gross was net of hedging costs, currency translation, pursuit costs (dead deal costs), credit facility interest if utilized to bridge equity, audit and legal expenses, and accounting overhead if reimbursed by the fund. Net was net of the fund management fee and GP Carry.

As of June 30, 2002, the survey revealed that many top-tier funds were projecting net returns to investors in the range of 15.5 percent to 18.0 percent on their recent vintage funds (1999–2000). The few funds that were projecting returns in excess of this were generally first-time funds that had few realizations. An examination of the handful of top performers, funds that have delivered top returns on a

consistent basis relative to their peers (based on vintage year of the fund), reveals the extent to which returns have declined since the early 1990s. Funds that once delivered net returns in excess of 40 percent are now projecting returns in the range of 15.5 percent to 18.0 percent. Many others are projecting net returns below 15 percent, with some even below 10 percent (Figure 1).

If the opportunities for 18 percent net returns have dried up, so be it. Large market dislocations that allow for 18 percent plus net returns are cyclical. However, GPs should not be compensated with 20 percent of total profits for generating net returns between 12.5 percent and 20 percent as current compensation structures allow. Opportunity funds that deliver net

Figure 2: Total load and fund expenses vs. Net projected IRR



returns to investors below 20 percent are generally overcompensated, particularly in the range of returns between the preferred return and the minimum return promised to investors of 20 percent.

Figure 2 plots the total load and fund level expenses for the opportunity funds surveyed. Each fund is represented by two data points, one (total load) directly above the other (fund expenses). For example, the highest returning fund has a projected net return to investors of 42.7 percent and a total (fee and expense) load of 5.5 percent.

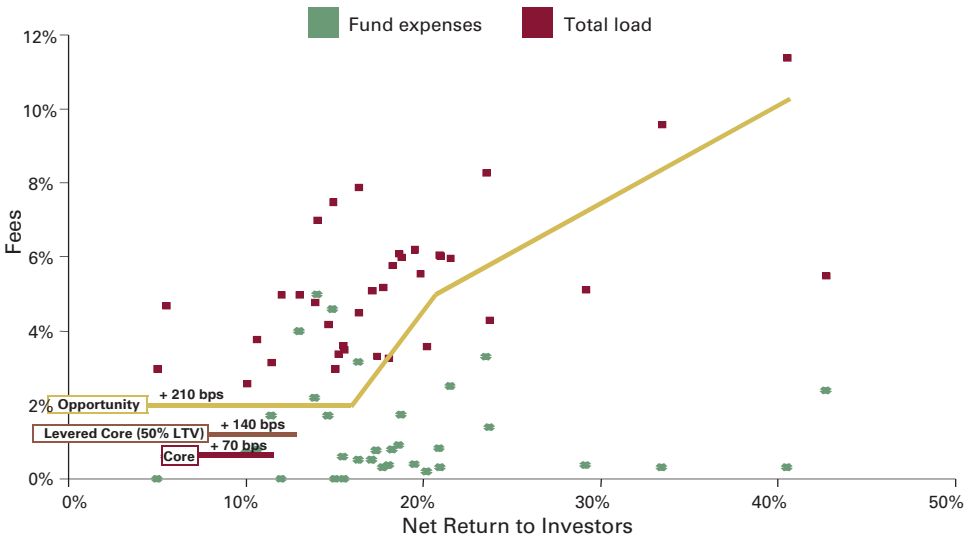
It is more expensive to run an opportunity fund platform, especially if it is global in scope. However, opportunity funds are compensated at levels that exceed fees for a core manager. The minimum load on an

opportunity fund should be approximately 210 basis points on equity, as established by the load on a core portfolio levered to the same extent. However, sadly, the surveyed funds that are delivering net returns in the range of 0 percent to 10 percent have fee loads of 300 to 450 basis points. The velocity of investing is a factor here, due to fees being paid on committed rather than invested equity.

INVESTOR, BLAME THYSELF

Now is the time for investors to bring fee structures into alignment with the returns being projected and delivered. As long as funds deliver an acceptable level of return, nothing is being taken away from the GP's

Figure 3: Alternative Fund Compensation Structures



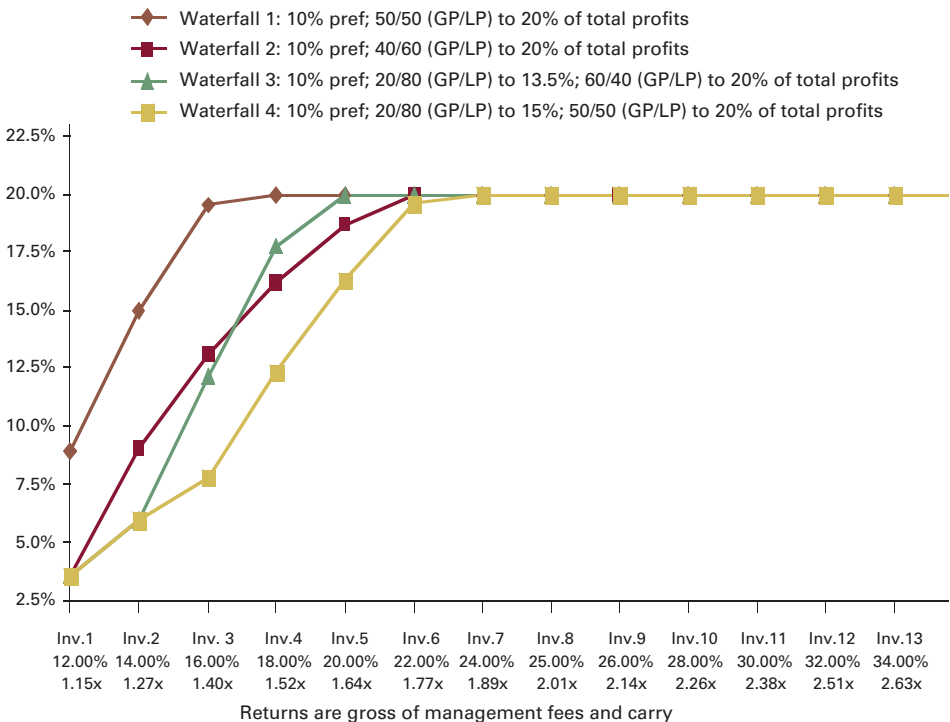
compensation. In this interest rate environment, investors should insist that the preferred return be roughly 15 percent, and that the catch-up be slowed down such that the GP achieves 20 percent of total profits only when the investor nets at least 20 percent. Additionally, funds should have claw-backs of 100 percent of the after-tax carry on a portfolio basis to ensure that the investor achieves its preferred return, and that the manager never receives more than 20 percent of total profits.

Figure 3 superimposes a recommended fee load for various investment strategies

on the plot of surveyed performance. It reveals the extent to which the opportunity fund GPs are being over-compensated for returns that are below 20 percent net. Interestingly, the shape of the orange line is that of a free option: the GP has no downside risk, only upside opportunity.

There are a number of solutions to the misalignment of compensation and performance found at the lower levels of returns. Ideally, the GP should be judged and compensated on his de-leveraged returns; that is, on performance that is neutral to leverage. Alternatively, the structure might utilize a series of hard

Figure 4: Projected IRRs through liquidation (as of June 30, 2002)



IRR-based hurdles, eliminating the 20 percent of total profits concept, much as opportunity funds reward their operating partners. Alternatively, the preferred return could be increased and the catch-up slowed to provide higher returns to LPs before a GP has achieved a 20 percent profit share from “first dollar.” Figure 4 illustrates the effect and timing of GP compensation by slowing down the catch-up before reaching 20 percent of total profits.

Preferred return should reflect the interest rate environment in which the fund is raised or invested. For example, in the current environment, the preferred return should be 15 percent, which reflects projected core returns levered to 67 percent (net of fees). Thereafter, the GP should begin receiving a disproportionate share of the distributions: [50/50], [40/60 (GP/LP)] until the GP is caught up to 20 percent of total profits.

POOR PERFORMANCE

It is fascinating to observe the impact on organizations and GP motivations as the prospect for realizing carried profits evaporates. A number of GPs are currently looking for ways of generating additional fee income. There seems to be no limit to GP creativity in this endeavor. The GPs guiltiest of stretching the limits are those

that are producing little or no carry. Conversely, the funds that are performing well seem to have GPs that are transparent and have not sought to generate fees from new sources. However, investors should not assume that the latter group is incapable of morphing into the former should carry become scarce for them.

Many ethical GPs created “asset management affiliates,” run at cost, to provide in-house expertise in markets where the expertise did not exist. An added benefit to their funds is the avoidance of an additional layer of promote, and the direct control over the local partner. “At cost” evolved into “cost plus 10 percent” and the desire to use the affiliate for more than just specialized services, such as resolving non-performing loans (NPLs) in overseas markets. The next stage was the migration of personnel from the GP to the affiliate, with the end result that GP overhead was shifted from the GP to the affiliate, which was then reimbursed by the fund. In this way, some GPs found a way to generate profit from their asset management affiliate fees through a virtual elimination of their overhead.

A variation is the asset management affiliate that is not reimbursed at cost, but charges fees to the fund: base asset management fees, acquisition and disposition fees, and incentive fees. This structure is sometimes described as being necessary in order to satisfy the foreign tax authorities.

The result is affiliates with 15 times more employees than the GP that make a large profit in spite of fund performance. GPs argue that they are not making a profit because they are still recovering their start-up costs. However, if the fund pays start-up costs, don't all of the eventual profits from the affiliate really belong to the fund?

A fund should never be allowed to charge unspecified fees to an affiliate, subject to the approval of an advisory committee. Additionally, the asset management affiliate must always be staffed separately from the GP, reimbursed by the fund at the lesser of market or cost plus 7 percent to 10 percent. The only protection for investors is to insist on documentation that leaves no latitude for the GP to devise additional sources of revenue at its discretion.

CONCLUSION

Investors must take the lead in the continuing evolution of real estate equity vehicles. There must be a continuum along the risk and return spectrum of fees paid for performance so that GPs are paid relative to the returns they deliver. Ideally, the GP should be judged and rewarded based on his de-leveraged performance, a standard that is neutral to the amount of leverage utilized. Since this probably isn't

practical, the preferred return should equal the net return from core, leveraged to 67 percent (roughly 15.0 percent). After the preferred return, the GP should receive a disproportionate share of distributions that will catch-up the GP to 20 percent of total profits at a net 20 percent IRR to the investors.