Adjusting Opportunity Fund Fees

An examination of the fees charged by real estate opportunity funds. How does the investment environment impact fees?

JOANNE DOUVAS

REAL ESTATE OPPORTUNITY funds gained prominence in the early 1990s, when investors took advantage of the lack of capital in real estate markets. Early funds advertised minimum net returns of 18 percent to 20 percent, and delivered twice that. Sponsor general partners (GPs) were rewarded with management fees of 1.5 percent on committed capital, plus 20 percent of total profits. Opportunity funds and their GPs are now a permanent fixture. Although real estate markets have generally corrected, capital continues to flow even as the likelihood of achieving net returns of 20 percent or more has fallen. This article explores opportunity fund fee structures and the disconnect that can arise between compensation and investment performance under varying market conditions. High core returns and low interest rates dictate higher fund preferred returns, and slower catch-ups, while low core returns and high interest rates should dictate lower preferred returns. Additionally, we examine the effect of fund leverage and the extent to which GPs are compensated for its use.

OPPORTUNITY FUND STRUCTURES

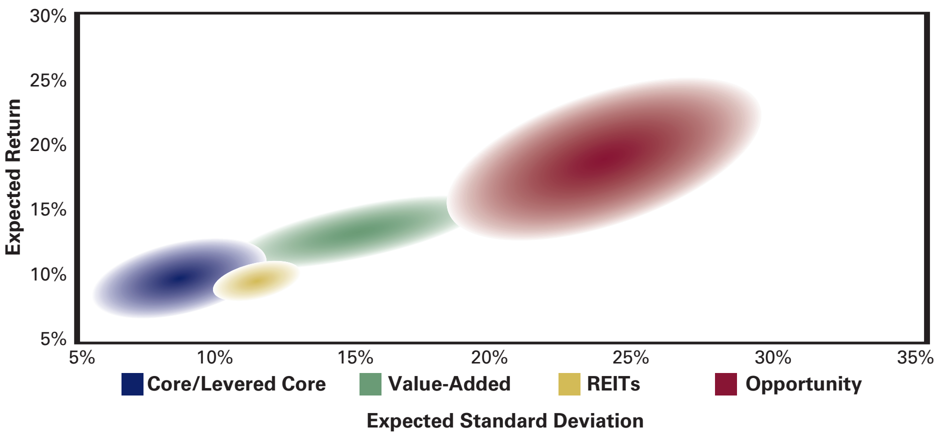
Opportunity fund structures offer a range of terms and conditions, resulting from prior performance/history, size of the fund, investment strategy, founding limited partners, and capital flows. Generally, there is a preferred return, or pref, to investors of 9 percent to 11 percent; a catch-up until the GP receives 20 percent of total profits; and a fund management fee of 150 basis points (bps), often reduced for commitments in excess of $75 million. The fund invests capital during a three- to four-year commitment period, during which the GP receives a fee on committed (versus invested) capital, and is generally reimbursed for a variety of costs that a core manager would not receive. These costs include fund organizational expenses, accounting department overhead, travel, and dead-deal costs. Some funds also have acquisition fees of 50 to 100 bps on gross acquisition price. For a 75 percent leveraged purchase, this fee represents 200 to 400 bps on invested equity. To varying degrees, funds also have clawback provisions to ensure investor distributions. Funds allow for distributions of GP carry either on a deal-by-deal basis with a clawback, or on a portfolio basis, which mitigates the need for a clawback.

The cornerstone of the private equity model is that fees should reflect performance, and that the interests of GPs and investors are aligned. Fees should reflect the risk and return, with the GP being rewarded with a share of the profits for delivering performance. But GPs should only receive outsized rewards for exceptional performance. By way of comparison, from 1996 to 2000, a fund that bought the NCREIF Index at a 75 percent loan-to-value (LTV) would have achieved a gross return of 29.5 percent. GPs should not be rewarded with outsized fees just for utilizing leverage and matching underlying real estate performance.

Investors have a wide range of alternatives to execute their real estate investments. The strategies are generally core, leveraged core, value-added, and opportunity (Figure 1). Expected gross investor returns from an unleveraged U.S. core strategy are currently 6.0 percent to 7.75 percent. At 30 percent to 50 percent leverage, the gross returns rise to 6.1 percent to 9.75 percent. The risk premium over core for a value-added strategy should be in the range of 100 to 200 bps on an unleveraged basis. Therefore, targeted gross returns from a value-added strategy with 50 percent to 65 percent leverage should be at least 11.75 percent to 14.3 percent. The appropriate risk premium over core for an opportunistic strategy is in the range of 200 to 400 bps on an unleveraged basis. With a 200 bp risk premium, the gross return an opportunity fund should deliver is 17 percent to 26 percent or more, with a net investor return of 12 to 19 percent or more.

The total fee associated with a core open-ended fund (unleveraged) is approximately 70 basis points on invested capital. Adding leverage and assuming the risk of a repositioning strategy results in approximately 140 to 400 bps total GP compensation on equity for value-added investments. An opportunity fund with gross returns of 17 percent to 26 percent generates 20 percent of total profits for the GP, plus the fund management fee, or approximately 500 to 700 bps.

Figure 1: Risk and return assumptions for various investment strategies



	Gross Return Range	Fees	Net Expected Return	Volatility	Leverage
Unlevered Core	6.0% to 7.75%	0.70%	5.3% to 7.05%	8% to 8.5%	0%
Levered Core	6.1% to 9.75%	1% - 1.4%	5.1% to 8.35%	9.5% to 10.5%	30% to 50%
REITS	8% to 9%	0.70%	7.3% to 8.3%	12.5% to 13.5%	45%
Value-Added	11.75% to 14.3%	1.4% to 4%	10.3% to 12.3%	10.5% to 20%	50% to 65%
Opportunity Funds**	17.1% to 25.8%+	5% to 7%+	12% to 19%+	21% to 31%	65% to 80%

Assume fees within bands are positively related to performance
Assume volatility is positively related to performance for value added and opportunity
Assumes interest of 5.75%, 100 bps premium over unlevered core for value-add and 200 bps for opportunity
** Includes International and assumes minimum of 200 bps premium over Unlevered Core

THE MISALIGNMENT

For a fund with a 10 percent pref and a 60/40 catch-up split (60 percent to the GP, 40 percent to investors), the opportunity fund GP receives 20 percent of total profits at a net return to investors of 12.5 percent, and a gross return of 17.5 percent. In an environment of 9 percent unleveraged returns, and 5.5 percent interest rates, a core manager could leverage to 75 percent LTV and achieve a 16.7 percent net return with a fee drain of 280 bps. But why should an opportunity fund GP be paid 500 bps for delivering a net 12.5 percent return when the core manager can deliver a 16.7 percent net return for 280 bps? GPs should not be rewarded just for utilizing leverage. Put another way, investors can readily achieve a 12.5 percent net return with less risk—and save 500 bps in fees—by leveraging core investments. An unleveraged gross return of 7.3 percent can be leveraged 70 percent to 75 percent LTV at a 5.5 percent interest rate to achieve a net return of 9 percent to 10 percent—the standard pref over which the GP receives a share of the profits.

Core real estate managers are typically paid 70 bps on gross asset value, with value marked to market annually. The opportunity fund GP is paid a fund management fee of 150 bps on committed equity, which if leveraged to 75 percent means that he is paid 37.5 bps on gross value. Thus, the opportunity fund GP is generally paid less than the core manager prior to earning a performance fee or carried interest. This is not necessarily inappropriate, as opportunity fund GPs invest substantial amounts of capital, and are reliant on the operating expertise of others in deploying and managing capital. They heavily utilize debt at both investment and fund levels. The opportunity fund GPs desire to receive reasonable fees to cover their overhead. The reward for delivering returns commensurate with risk is their 20 percent share of profits.

Real estate opportunity funds modeled their basic structures on private equity funds. Investors gladly pay 20 percent of total profits for net LP returns that exceed 20 percent. Only if funds fail to deliver 20 percent net internal rates of return

Figure 2: Core fees

LTV (%)	BPs on Equity
0	70
30	100
35	108
40	117
45	127
50	140
55	156
60	175
65	200
66.6	210
70	233
75	280
80	350
85	467

Figure 3: Core returns gross of fee (assuming unleveraged core achieves 9%)

Loan-to-value (LTV)		60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	13.5	15.0	16.0	18.0	21.0	26.0
	5.5 %	14.3	16.0	17.2	19.5	23.0	28.8
	5.0 %	15.0	17.0	18.3	21.0	25.0	31.7
	4.5 %	15.8	18.0	19.5	22.5	27.0	34.5
	4.0 %	16.5	19.0	20.7	24.0	29.0	37.3

Figure 4: Core returns net of core fee (assuming unleveraged core achieves 9%)

Loan-to-value (LTV)		60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	11.8	12.9	13.7	15.2	17.5	21.3
	5.5 %	12.5	13.9	14.8	16.7	19.5	24.2
	5.0 %	13.3	14.9	16.0	18.2	21.5	27.0
	4.5 %	14.0	15.9	17.2	19.7	23.5	29.8
	4.0 %	14.8	16.9	18.3	21.2	25.5	32.7

(IRR)—or, worse, fail to deliver returns that exceed leveraged core returns—does a problem arise. The problem is that GPs are being compensated extremely well for failing to deliver a risk-adjusted return.

While it is rare to use more than 50 percent LTV on core investments, the effect of leverage (expressed as basis points on equity) on fees is summarized in Figure 2. There is simply no reason for a fund GP to be paid more than a core manager for achieving the same unleveraged return. Figures 3 and 4 show the effect of leverage on core returns in an environment of 9 percent unleveraged core returns, both gross and net of fees, for alternative levels of leverage and interest rates.

The GP receives a base fund management fee of 1.5 percent, regardless of performance. This fee, intended to cover reasonable overhead, is typically charged on committed capital during the three- to four-year investment period, and then steps down to 1.5 percent of unreturned capital. This fee is treated as contributed capital in calculating the carry. If money is invested slowly, the impact of this fee is exaggerated. Comparing this fee to that earned by the core manager for a given level of leverage indicates what the carry must be to equate GP fees to those earned by a core manager. One can also calculate the pref for 60/40 or 50/50 catch-ups (Figures 5 and 6). Setting the pref at this level or higher ensures that the fee earned by the opportunity fund GP does not exceed that of the core manager for delivering a leveraged core

Figure 5: Preferred return to begin 60/40 catch-up loan-to-value (LTV)

	Loan-to-value (LTV)	60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	11.6	12.5	13.1	14.3	16.2	19.2
	5.5 %	12.3	13.5	14.3	15.8	18.2	22.1
	5.0 %	13.1	14.5	15.4	17.3	20.2	24.9
	4.5 %	13.8	15.5	16.6	18.8	22.2	27.7
	4.0 %	14.6	16.5	17.8	20.3	24.2	30.6

Figure 6: Preferred return to begin 50/50 catch-up loan-to-value (LTV)

	Loan-to-value (LTV)	60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	11.5	12.3	12.8	13.9	15.5	18.2
	5.5 %	12.2	13.3	14.0	15.4	17.5	21.0
	5.0 %	13.0	14.3	15.2	16.9	19.5	23.8
	4.5 %	13.8	15.3	16.3	18.4	21.5	26.7
	4.0 %	14.5	16.3	17.5	19.9	23.5	29.5

Figure 7: Core returns gross of fee (assuming unleveraged core achieves 7%)

	Loan-to-value (LTV)	60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	8.5	9.0	9.3	10.0	11.0	12.7
	5.5 %	9.3	10.0	10.5	11.5	13.0	15.5
	5.0 %	10.0	11.0	11.7	13.0	15.0	18.3
	4.5 %	10.8	12.0	12.8	14.5	17.0	21.2
	4.0 %	11.5	13.0	14.0	16.0	19.0	24.0

return. If the opportunity fund achieves better performance, the GP makes more money. For a fund maintaining 75 percent leverage in a 4.5 percent interest rate environment, with unleveraged core investments delivering 9 percent returns, the pref should be set at 18.8 percent utilizing a 60/40 catch-up, and 18.4 percent with a 50/50 catch-up.

In an environment of 7.0 percent unleveraged core returns, such as the current U.S. market, the picture is very different, as leverage is much less accretive to the core returns. Today, opportunity GPs are pushing leverage from 65 percent to 75 percent to as high as 80 percent to 85 percent. GPs are also heavily utilizing fund level credit facilities in lieu of drawing committed capital, benefiting the GP by reducing the period over which they pay the pref. Figures 7 and 8 are analogous to Figures 5 and 6,

Figure 8: Core returns net of core fee (assuming unleveraged core achieves 7%)

Loan-to-value (LTV)		60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	6.8	6.9	7.0	7.2	7.5	8.0
	5.5 %	7.5	7.9	8.2	8.7	9.5	10.8
	5.0 %	8.3	8.9	9.3	10.2	11.5	13.7
	4.5 %	9.0	9.9	10.5	11.7	13.5	16.5
	4.0 %	9.8	10.9	11.7	13.2	15.5	19.3

Figure 9: Preferred return to begin 60/40 catch-up

Loan-to-value (LTV)		60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0 %	6.6	6.5	6.4	6.3	6.2	5.9
	5.5 %	7.3	7.5	7.6	7.8	8.2	8.7
	5.0 %	8.1	8.5	8.8	9.3	10.2	11.6
	4.5 %	8.8	9.5	9.9	10.8	12.2	14.4
	4.0 %	9.6	10.5	11.1	12.3	14.2	17.2

Figure 10: Preferred return to begin 20% GP distribution (assuming unleveraged core return of 9%)

Loan-to-value (LTV)		60 %	67 %	70 %	75 %	80 %	85 %
Interest Rate	6.0%	10.8	10.5	10.3	10.0	9.5	8.7
	5.5%	11.5	11.5	11.5	11.5	11.5	11.5
	5.0%	12.3	12.5	12.7	13.0	13.5	14.3
	4.5%	13.0	13.5	13.8	14.5	15.5	17.2
	4.0%	13.8	14.5	15.0	16.0	17.5	20.0

except they assume an unleveraged core return of 7 percent.

Today's preferred return might be set at roughly 8.2 percent so as to not penalize the opportunity GP relative to the core manager for delivering the same unleveraged return (Figure 9). However, setting the pref at this level rewards the opportunity GP for delivering a corelike return with opportunistic risk. There must be a risk premium associated with the strategy deloyed. Additionally, the fee for an opportunity fund before carry should not be the same as for core managers.

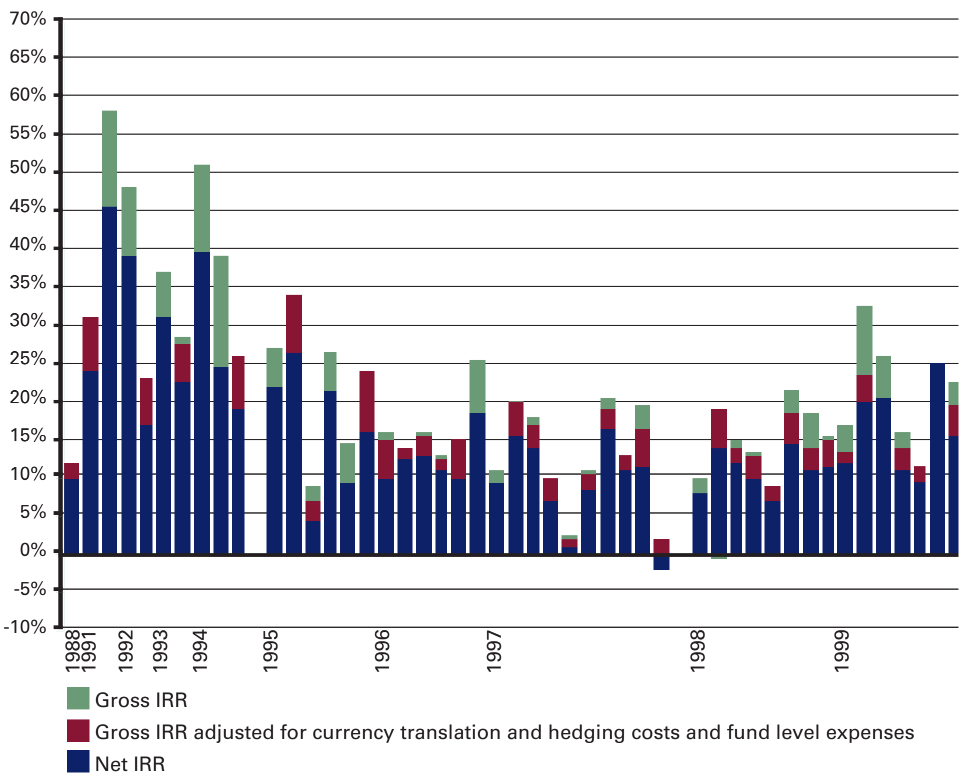
RISK AND PERFORMANCE

Backing into the pref, so that the total fees equate to core fees for equivalent leverage, indicates that in a 9 percent unleveraged core environment, the pref should be well in excess of 10 percent, even before adding a strategic risk premium (Figure 10). In a 7 percent unleveraged core environment, the pref should be no less than the net return from core leveraged to 75 percent, plus 150 bps for the fund management fee, plus a 200 bp risk premium. This yields a 10 percent to 11 percent pref.

To understand how opportunity funds are expected to perform on a net basis, and their associated fees, we surveyed the performance of 96 funds (representing $62.4 billion in invested equity) (Figure 11). We surveyed their IRRs since inception, utilizing both current fair market value (FMV) at reversion, and as projected through liquidation. The relevance of the FMV returns is undermined by the lack of consistent valuation policies across funds, and because many funds hold investments at cost until realization.

We also surveyed their gross returns, gross returns net of hedging and currency translation costs, adjusted gross, and net investor returns. Gross return is defined as the fund's investment level IRRs in local currency net of debt. Adjusted gross is net of hedging costs, currency translation,

Figure 11: Performance graphed by vintage year



dead deal costs, credit facility interest if utilized to bridge equity, audit and legal expenses, and accounting overhead if reimbursed by the fund. Net LP return is net of all fund fees and carry.

In theory, opportunity fund performance should be correlated with core performance with equivalent leverage, plus a risk premium. However, this is not the case. Our survey (as of December 31, 2005) reveals that many funds raised between 1995 and 1999 by top-tier GPs are projecting net returns to investors in the range of 10 percent to 14 percent. Ironically, this was a period in which there was a 500 bp spread between core real estate returns and borrowing rates. It is reasonable to expect that the opportunities for 18 percent net investor returns diminish as market dislocation equilibrate. However, GPs should not be compensated with 20 percent of total profits for net investor returns that are less than core with equivalent leverage. Perhaps the opportunity is merely value-added, in which case the GP should be compensated with 20 percent of distributions over an appropriate preferred return, with no catch-up.

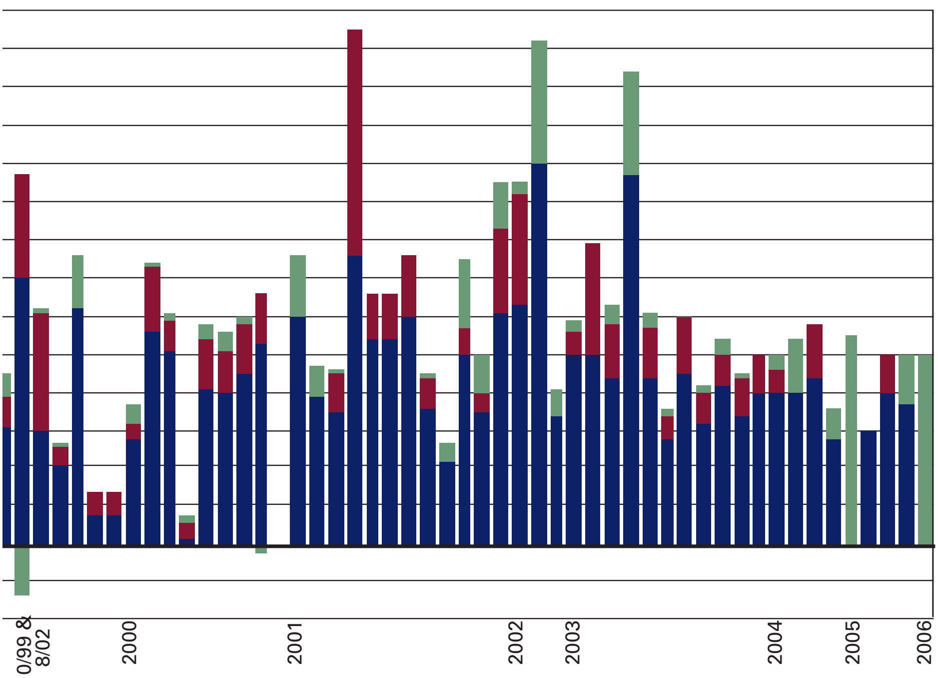
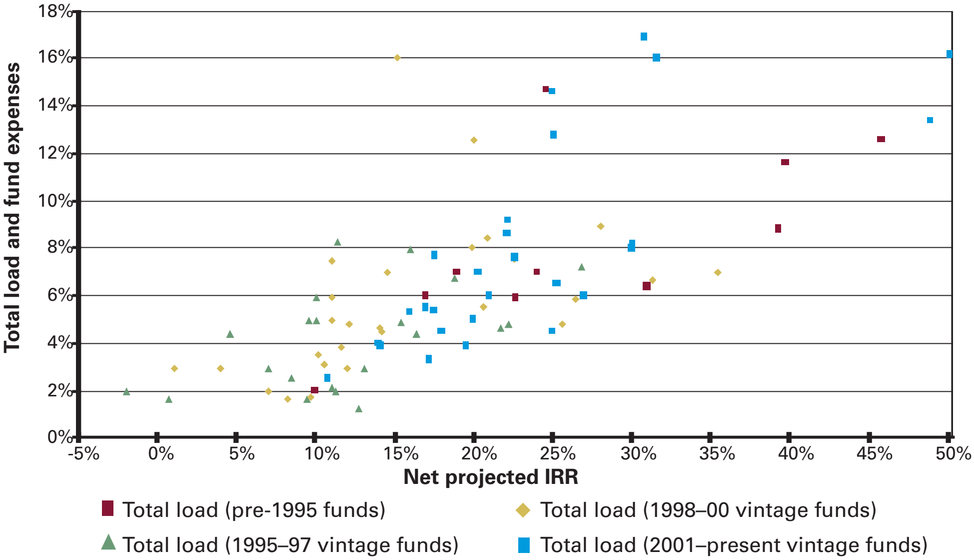


Figure 12: Total load versus net projected IRR



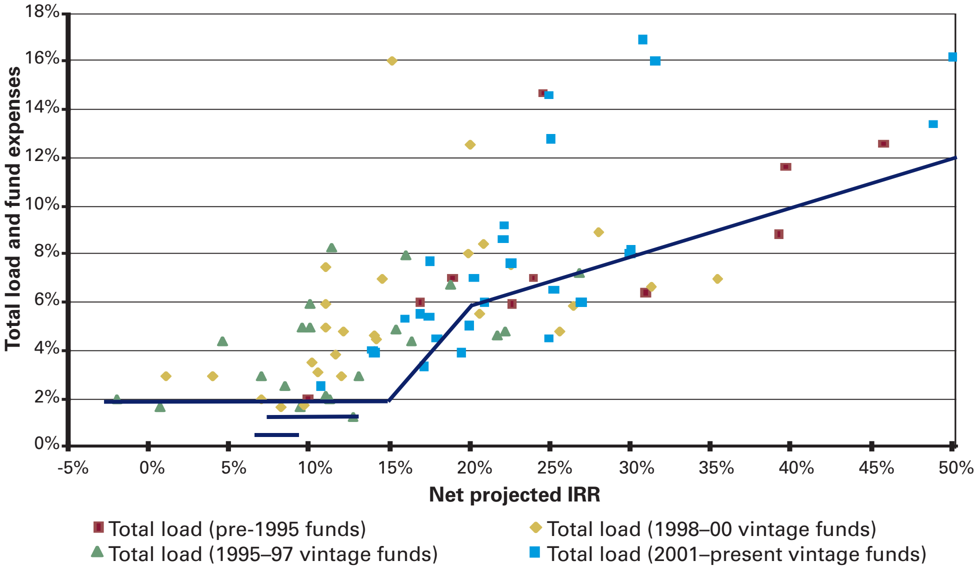
Adding a catch-up that begins at a higher level allows the opportunity GP the ability to earn opportunistic fees for higher returns. Opportunity funds that deliver net investor returns below 14 percent are generally overcompensated if the catch-up begins at a 9 percent to 10 percent pref.

Fee structures must be continually adjusted to reflect the market environment. Prefs need to be adjusted upwards from 9 percent to 10 percent for value-added funds, and 10 percent to 11 percent for opportunity funds, when leveraged core returns exceed the point at which the GP is caught up to 20 percent of total profits. Alternatively, the point at which the catch-up begins might be delayed, with the GP receiving 20 percent of distributions between the preferred return and the beginning of the catch-up. As long as the funds deliver an acceptable net investor return, nothing is taken from the GP's compensation.

In the current environment of 7 percent unleveraged core returns, investors should insist that the pref is no lower than 10 percent to 11 percent, and that the catch-up is reduced such that the GP achieves 20 percent of total profits only if investors net 14 percent to 16.5 percent returns. Additionally, funds should have 100 percent clawbacks of the after-tax carry on a portfolio basis to ensure that the investors achieve their preferred return, and that the GP never receives more than 20 percent of total profits.

Superimposing the ideal fee load for various investment strategies on the graph

Figure 13: Total load versus net projected IRR



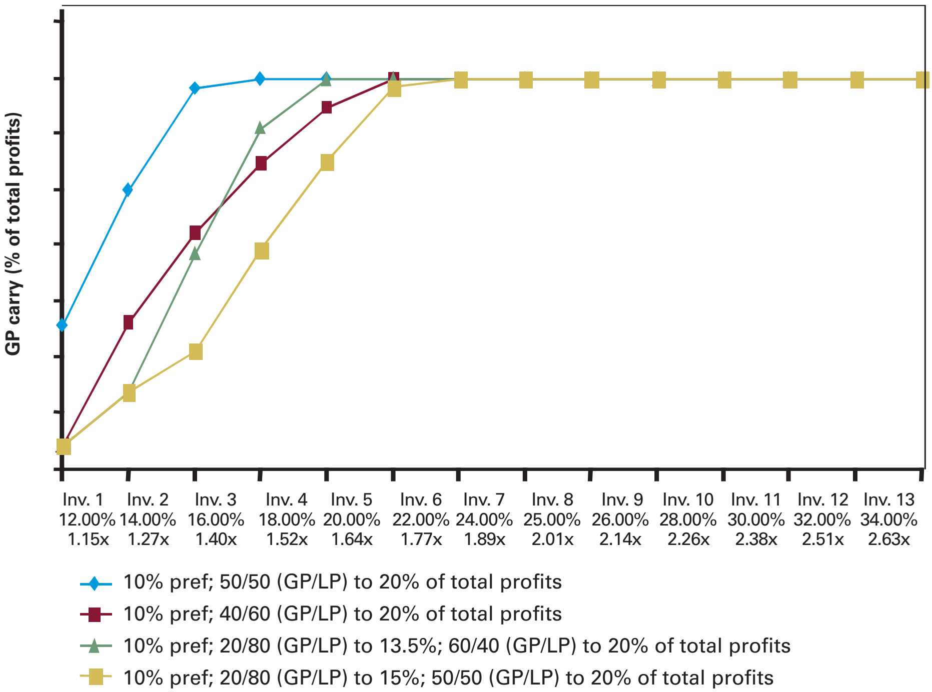
in Figure 12 reveals the extent to which the opportunity fund GPs were over-compensated for below 20 percent net investor returns (Figure 13). Interestingly, the shape of the relationship is that of a free option: the GP has no downside risk, only upside risk.

WHAT IS TO BE DONE?

There are a number of possible solutions to the misalignment of compensation and performance that occurs at lower levels of returns. Ideally, the GP should be compensated primarily on performance neutral of leverage. Alternatively, the structure might utilize a series of hard IRR-based hurdles, eliminating the 20 percent of total profits concept, much as the opportunity funds reward their operating partners. Or, the pref could be increased and the catch-up slowed, to provide higher returns to investors before the GP realizes 20 percent of profits from “first dollar.” Figure 14 illustrates the effect and timing of GP compensation resulting from slowing down the catch-up.

Ideally, the pref should be a function of the interest rate environment in which the fund is raised and invested. In today’s environment, the pref should be at least 10 percent to 11 percent. This would reflect current core returns leveraged to 75 percent net of fees, plus 1.5 percent for the

Figure 14: Alternate fund compensation structures



fund management fee, plus a 200 bp risk premium. Thereafter, the GP should earn 20 percent of distributions until investors have received a net 12.5 percent to 15.0 percent return. Then the GP should receive a disproportionate share of the distributions—until the GP is caught up to 20 percent of total profits.

It is fascinating to observe the impact on GP motivations when the prospect for realizing carried profits evaporates. In the face of weak performance, a number of GPs have discovered ways to generate additional income. Some have created "asset management affiliates," run at cost, to provide in-house expertise in markets where the expertise did not exist. This avoids a layer of partner promote, and provides control over the operator. However, "at cost" often evolves into "cost plus 10 percent."

GPs have also used these affiliates for more than just specialized services, such as to resolve non-performing loans in overseas markets. Also, personnel from the GP magically migrate to the affiliate, shifting GP overhead to the affiliate, which is then reimbursed by the fund. In this way, some GPs have generated profit from their management fees through the virtual elimination of "their" overhead.

A variation is the asset management affiliate that charges fees to the fund (base asset management fees, acquisition and disposition fees, and incentive fees). This structure is defended as being necessary in order to satisfy the foreign tax authorities. But the result is affiliates with many more employees than the GP, and a GP that makes large profits in spite of weak fund performance. GPs argue that they are not making a profit because they are still recovering their start-up costs. But, if the fund pays start-up costs, should not all of the eventual profits from the affiliate 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. Asset management affiliates should be staffed separately from the GP, and reimbursed by the fund at the lesser of market, or cost plus 7 percent to 10 percent. Additionally, employees of a fund should not be allowed to buy property from fund investments. The only protection for investors is to insist on fund documents that leave no latitude for the GP to devise additional sources of revenue.

Fee structures must better reflect the risk, return, strategy, and market condiditons in which these funds operate. Investors must take the lead in the evolution of real estate equity vehicles. Ideally, the GP should be rewarded primarily on a return standard that is neutral to leverage. Since this may not be practical, the pref should equal the net return from core leveraged to 75 percent plus the 1.5 percent fund management fee, plus a 200 bp risk premium (roughly 10 percent to 11 percent currently). After the pref, the GP should receive 20 percent of distributions until investors have received a net return of 12.5 percent to 15.0 percent, then a disproportionate share of distributions. The end result will be a fee that is aligned with the risk and return.