

REAL ESTATE FINANCE

THE QUARTERLY REVIEW OF COMMERCIAL FINANCE TECHNIQUES

VOLUME 18, NUMBER 4

WINTER 2002

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How Does This Fee on Fee Thing Work?

There has been considerable discussion lately of the total fee load on high yield real estate funds. A few numbers are needed to analyze the magnitude and impact of those fee structures. It is easy to get lost in the possibilities, so “staying with the most common” is appropriate for the first pass.

The traditional real estate investment management fee structure provides a context for analysis of the fee structure on the higher yield products. While the traditional “core” investment managers have come up with a host of modest incentive fees, as well as some more creative acquisition and disposition fees, the total fee load has remained about 100 basis points for some time.¹

The historical total return on such core real estate investments has been 9.5% (NCREIF annual total return since inception in 1978). Thus, the net return is 9.5% less 1.0% or 8.5%. The total fee load is 1% of assets or 10.5% of total return ($1\% \div 9.5\%$).

The “typical” opportunity fund charges 1.5% asset management fee plus 20% of realized returns as a “participation.”² Staying with the most common, we will assume no games with fees on “undrawn” capital commitments. This first pass at the issue will also ignore the increasingly common practice of borrowing against commitments rather than drawing down commitments. This practice reduces the equity invested, thus increasing the IRR and positively impacting the investment management fee. Combining the leverage with fees on committed but undrawn capital substantially increases total investment management fees.

Frequently, opportunity funds invest in development projects and that structure provides a relatively straightforward look at the fee on fee issue. The value add by the opportunity fund is finding the right development, finding the right developer, and structuring the transaction. The local developer gets a development fee and a “promote.” In theory, the development fee is for the work done and the promote is the entrepreneurial element which aligns interests.

Again staying with the most common, assume a 5% development

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fee on total cost. While there is often some profit for the developer in this fee, for the sake of this example, we will assume that the entire 5% development fee covers only legitimate out of pocket costs, leaving all the developer's profit in the promote.

Let's assume a three-year project with \$100M in total costs including construction loan interest, the developer fee, and all other "soft costs." The capital structure would typically be:

Bank Construction Loan	\$75M
Opportunity Fund Equity	20M
Developer Equity ³	5M

The promote structure might look something like the following:

- First, cash flow to repay the bank.
- Next, return opportunity fund equity plus a 12% return.
- Third, return developer equity plus a 12% return.
- Then, the return is split 70% to the opportunity fund and 30% to the developer until opportunity fund achieves a 15% return.
- Then, the return is split 60% to the opportunity fund and 40% to the developer until opportunity fund achieves a 20% return.
- Any remaining profit is split 50-50.

The best case for contemporary development is a "build to" 12% yield in a 9% capitalization rate market. This means the development project when completed and leased will produce an annual yield of 12% on the total investment and that the market price for the completed project will be that yield capitalized at 9%. In our example, the \$100M project yields \$12M. The project will be sold upon completion (three years) for \$133M ($\$12M \div 9\%$).

The equity investment of \$25M (\$100M total less \$75M bank loan) returns \$58M (\$133M sale price less \$75M bank loan) or a profit of \$33M ($\$58M - \$25M$). (The bank's interest is included in total project costs.) This is a 32% IRR over the three year hold—a great return at the deal level.

Here is how the \$58M gets divided between the developer (first fee), the opportunity fund investment manager (second fee), and the investor.

	Opportunity Fund	Developer
Principal + 12% ⁴	\$28.10M	\$7.02M
Next 3% to total of 15%	2.32	.99
Next 5% to total of 20%	4.14	1.78
Remainder of \$58M		
less amounts above	6.82	6.82
Total	41.38	16.62
Profit	21.38	11.62
IRR	27.4%	49.2%
% of Total Profit	64.8%	35.2%

Next the investment manager takes the base fee (1.5% per year) plus the 20% incentive fee.

Base 1.5% × 3 × \$20M	= \$ 900,000
Incentive 20% × \$21.38	= 4,276,000
Total	\$5,176,000

This is 15.7% of the total profit of \$33M or 24% of the opportunity fund profit. It directly reduces the investor's return from the fund return of \$21.38M to \$16.2M, or 49% of the total profit. The investor's net IRR is 21.9%.

What happens if target rents are not achieved and the project is "built to an 11% yield"? This is still a major winner. Now the \$100M project produces an \$11M yield, which means a sales price of \$122M ($\$11M \div .09$). The project IRR is still a healthy 23% while profit is now \$22M and the splits are:

	Opportunity Fund	Developer
Principal + 12%	\$28.10M	\$7.02M
Next 3%	2.32	.99
Next 5%	4.14	1.78
Remainder of \$47M		
less amounts above	1.32	1.32
Total	35.88	11.12
Profit	15.88	6.12
IRR	21.5%	49.2%
% of Total Profit	72.2%	35.2%

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Now the developer's share is less since the project is not as successful. That much is quite reasonable.

Again the investment manager takes a base fee plus the 20% incentive fee:

Base 1.5% × 3 years × \$20M	= \$ 900,000
Incentive 20% × \$15.88	= 3,176,000
Total	\$4,076,000

This is 18.5% of the total profit of \$22M. It directly reduces the investor's return to \$11,804 or 53.7% of total profit. The investor's net IRR is 16.7%. Note that while the developer's percentage went down, the investment manager's percentage actually went up.

Being a positive person, I never think about real losers, but let's look at a third, more modest winner. Now market pressures force even lower rents so the project is built to a 10% yield (rather than the initial projection of a 12% yield). This is still a winner since the market prices this income stream at a 9% yield. The project now sells for \$111M (\$10M ÷ .09). The project IRR is 12.9%. The splits are:

The investment manager takes the same base fee and a lower incentive fee.

	Opportunity Fund	Developer
Principal + 12%	\$28.10M	\$7.02M
Next 3%	2.32	.99
Total	35.88	11.12
Profit	15.88	6.12
IRR	13.2%	12.0%
% of Total Profit	81.6%	18.4%

Base 1.5% × 3 years × \$20M	= \$ 900,000
Incentive 20% × \$8.98M	= 1,796,000
Total	\$2,696,000

This is 24.5% of total profit of \$11M. It reduces this investor's profit to \$6.28M or 57% of total profit. The investor net IRR is 9.5%

In the best case, the investor put up 80% of the money at risk (assuming a no profit development fee and no bank loan guarantee) and got 49% of the profits. The next two scenarios

showed the investor with the same exposure, but 53% and 57% of the total profit. Interestingly, the opportunity fund investment manager gets an increasing percentage of total profits as the deal worsens—15.7%, 18.5%, and then 24.5%. From a basis point perspective the opportunity fund investment manager is getting from 600 to 300 basis points from the best case to the last example. The total fee load ranges from 2,200 down to 550 from a basis point perspective. Clearly, this is a very different world than the traditional core example with about 100 basis points of total fee. Still, the investor net IRR is higher on even a modest win in these higher yield scenarios.

The real issue is the after fee risk/return position of the investor. With the investor getting only about half of the "deal profits," the investment winners (home runs) may not be big enough to offset the losers. When the timing and/or execution of higher risk heavily leveraged strategies go wrong, it isn't a fee problem. It becomes a lost principal problem.

Mike Miles
Editor

¹The fee for larger investors is slightly lower.

²Often the 20% is contingent on achieving some minimum return such as 5% real, or 8% total.

³A 90-10 split between the opportunity fund and the developer on contributed capital is probably more common than the 80-20 shown here. We use the 80-20 because it allows the development fee to exactly cover the developer's equity contribution and that greatly simplifies the subsequent calculations. Over the course of the development, the developer usually pays this 5% to himself and associates for work done. Again to keep the example as straightforward as possible, it is assumed that there is no profit in the development fee.

⁴Everything is negotiable in these transactions and one of the main value adds of the opportunity fund investment manager is structuring the deal properly. Depending on the relative strength of the parties, the developer may get his equity out at the same time as the opportunity fund. In this example, the opportunity fund is able to get the developer to have his equity at risk for the first 12% of the return to the fund. If there is a loan guarantee at the bank and the developer provides said guarantee, then it would be common for both parties to get back their equity at the same time as opposed to the fund getting out first.