Management fee, carried interest and other economic terms of real estate funds

The jargon associated with investing in a private real estate fund is numerous. Given that an investor is signing a contract to invest in a fund, and the sponsor of the fund is promising to manage the fund in certain ways, it is not surprising that legalistic language has permeated the real estate industry. The purposes of this article are twofold. First, to provide clear definitions and insights into the main fund terms associated with most (but not all) private real estate funds. Second, to provide an overview of fund terms that have stood the test of time and to highlight those that are currently being debated in the industry. This second part involves a look at the alignment issue – how fund terms align the interests of the fund sponsor and investor.

Fees

BASE MANAGEMENT FEE

In general, there is a base management fee that is charged to the fund and paid by investors. This fee should be designed to cover the day-to-day costs of investing in, managing and perhaps ultimately selling real estate. There are a variety of ways that this fee is structured. In some cases, there is a straight fee, say 1.5 percent on commitments to the fund. So, a commitment of $10 million will involve a fee of $150,000 normally billed quarterly to the investor. After the end of the investment period, the fee would normally be based on net invested capital (or words to that effect). The investment period is the period in which the fund is acquiring real estate assets and typically would be in the three- to four-year range.

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However, the level and basis of the base management fee can vary depending on the specific fund considered. A core fund might levy the fee on net asset value (or NAV – essentially the valuation of the underlying real estate less the debt). Some core funds still levy management fees on gross asset value (GAV) – although in most cases, the level of the fee would be lower to account for the leverage associated with the assets. There is a lot of debate in the industry about whether the fee should be charged on gross or net asset value in relation to core funds. The pro-GAV camp suggests that GAV represents a better proxy for the work required in managing a portfolio of assets. The pro-NAV camp argues that leverage can distort the fee when charged on GAV and calculating the fee based on NAV simply cuts through that distortion, as debt is excluded. The recent price correction, post-2008 global financial crisis, in commercial real estate meant that some core portfolios which went into the downturn with moderate to high leverage (45 percent to 70 percent loan-to-value or LTV) became ‘overleveraged’ after the price correction. For investors in those funds, it became a key issue that, although the manager was still being paid a smaller fee than before (because the values had fallen), the investors’ NAV or equity was in some cases severely impacted—and yet they were still paying a fee. In fact, when funds were compared on an apples-to-apples basis by calculating the fee load based on NAV (which is what investors care about), the funds with management fees based on GAV were shown to be ‘overloaded’ in certain cases due to the leverage effect. Generally, the market view is that an appropriately set fee on GAV with quantifiable leverage limitations probably offers good alignment, but that a fee on NAV is cleaner and offers overall stronger alignment.

There are certain closed-end funds that do not charge base management fees on commitments during the investment period, but charge fees on NAV. While these are not the market norm, they were a reaction to the following situation. Some funds were raised at the peak of the market and did not invest as markets collapsed in the face of the global financial crisis. Investors, who had just committed to a fund for say, 10 years, were suddenly paying fees on their full commitments despite a low prospect of that capital getting invested in the 2008-2009 period. To a certain extent, the fund sponsor had a valid counterargument: they were still appraising opportunities and running a team in order to do that. The fund sponsor also argued that overall alignment was good, particularly if they had co-invested their own capital in the fund and were personally paid part of the carried interest. This in some part explains why some of the new funds coming to the market in the 2008-2009 periods opted to have their base management fee on NAV rather than on commitments. One could also argue that a fee based on NAV could overly incentivize the fund sponsor to invest the capital so as to earn fees. From a big picture perspective, however, it is preferable to look at the overall alignment of fees and analyze how a combination of base fee, carried interest and catch-ups would impact the investor’s net of fee return.

**CARRIED INTEREST**

Carried interest is also known as carry, promote or performance fee. Put simply, carried interest is the profit that accrues to the fund sponsor. It is normal practice for a non-core strategy fund to have a preferred return or hurdle rate over and above which the carried-interest calculation would kick in, hence the term ‘distribution waterfall’ (see Figure 1). The first waterfall is that the investor is entitled to get all of its capital returned (including management fees, broken-deal costs and fund organizational expenses). The next level is dictated by the hurdle rate, the level of which can vary widely depending on which country or region the fund is investing in. There is a general view that the hurdle rate – whether 8 percent, 9 percent or 11 percent – should be set based on the underlying performance of the core real estate market. In such a way, the manager of the fund will be rewarded for outperformance by generating added value over and above normal market conditions. It is worth noting that some funds targeting emerging markets have higher hurdle rates than
those funds investing in established markets like the U.S. This spread reflects the incremental required return associated with the higher perceived risk in emerging markets relative to developed markets. Once the investor has received his capital back, and the hurdle rate has been reached, then the profit is generally split between the investor and the fund sponsor. Typically a fund sponsor might get 20 percent of profits over a hurdle rate of 8 percent or 9 percent.

Figure 1: Carried interest distribution waterfall

A minority of fund sponsors offer a tiered hurdle-rate structure with differing distributions of profit in each tier. For example, the structure might be 15 percent to the fund sponsor over a 9 percent hurdle and 20 percent over a 15 percent hurdle. While the market does buy into these funds, some commentators would argue that, although designed with the best intentions, it can skew the manager to take on additional risk in order to achieve that incremental share of profits. Once again it is difficult and probably misleading to opine on individual fee mechanisms. The key question is how the fund is set in terms of overall alignment on fees, sponsor commitment and buy-in of the team.

There are core funds that have a performance fee element to their fee structure. Sometimes this is linked to a market index, net operating income (NOI) or to an absolute return. Given that most core funds have some element of leverage, it is important that, if a market-type benchmark is being used, there is a like-for-like comparison in terms of leverage. An NOI-based performance fee offers alignment with the income yield orientation of core investment strategies. Another issue with performance fees on core funds is whether the performance is unlimited (as is the case with their opportunity fund cousins) or limited by a cap. At the very least, a cap is appropriate given the nature of core funds being low-risk vehicles for investors to access real estate. This leads to the overall challenge of applying a performance fee to core funds – it creates an incentive for the fund sponsor to take on more risk for an investment strategy that is specifically designed to be at the low end of the risk spectrum.
CATCH UP

Catch-ups are more prevalent in the opportunity fund sector. This is a defined split of profits that go to the investor and fund sponsor. A high catch-up split would be 80/20 that is 80 percent to the fund sponsor and 20 percent to the investor until such time as the sponsor has received its 20 percent return on overall profits. Even though the catch-up mechanism would normally kick in at the preferred return – for example, 9 percent – it would mean that for every dollar of profit over and above the 9 percent return, the fund sponsor would get 80 cents until the sponsor has received its 20 percent return on overall profits. Clearly, post global financial crisis, there has been pushback from investors on the basis that it is their capital that is being managed and an aggressive catch-up skews the upside to the investor. Catch-ups do not exist in all opportunity funds, however. Many funds were launched in the 2008-2009 period with no catch-up provisions. In general, opportunity funds launched in 2010 and beyond with catch-up provisions have been 50/50 or 40/60 in terms of the split between the fund sponsor and the investor.

Clearly, the catch-up mechanism is an incentive to the fund sponsor to outperform the preferred return as they will get a high proportion of the overall profits. However, it is questionable how an aggressive catch-up – for example, 80/20 (fund sponsor to investor) – offers strong alignment where there is an appropriate balance of risk between the investor committing its capital, and the fund sponsor generating an appropriate level of incentive fee commensurate with good returns to the investor. Funds have been brought to the market without a catch-up provision – both value-added and opportunity funds. Where there is no catch-up provision, the preferred return is a hurdle rate over and above which the profits are shared in a defined way between the fund sponsor and the investor.

CLAWBACK

A clawback is where the fund sponsor and investors agree to use prior distributed profits to offset any shortfall in profits. To take an example of the following ‘since inception’ fund returns:

Figure 2:

<table>
<thead>
<tr>
<th>Year</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>15%</td>
</tr>
<tr>
<td>2</td>
<td>15%</td>
</tr>
<tr>
<td>3</td>
<td>15%</td>
</tr>
<tr>
<td>4</td>
<td>8%</td>
</tr>
<tr>
<td>5</td>
<td>5%</td>
</tr>
</tbody>
</table>

Source: Russell Investments

If we assume that the carried interest is 20 percent over a 10 percent hurdle, then the performance fee for the first three years would be 1 percent per year (that is, 20 percent of 5 percent). However, the fund had low performance in years 4 and 5, which pulls down the since-inception return to 8 percent in year 4 and to 5 percent in year 5. In this case, the clawback provision would kick in and certain amounts of the profit paid in years 1 to 3 would be used to offset the ultimate performance in years 4 and 5. In practice often an escrow account (or sometimes called a ‘segregated reserve account’) is used in to which a proportion (perhaps 50 percent) of the profits would be paid. Another term that is used is a ‘portfolio test’ where each distribution is subject to a test to ensure that the performance of the overall fund is given priority. For example, an individual deal that delivers a 30 percent return would clearly be above a 10 percent hurdle but if the overall fund was expected to perform at 8 percent (based on most recent valuations) then the portfolio test would ensure that the sponsor did not get paid for projected underperformance. It should be noted that a...
portfolio test is a ‘look-forward’ mechanism, and clawback is a ‘look-back’ one. It might seem that either clawback or a portfolio test should be in place, but it should be noted that having both would ensure stronger alignment.

ORGANIZATION AND FUND SET-UP COSTS

This is one of the more straightforward fees. This is where the costs of setting up and structuring the fund are expensed to the fund and ultimately paid by the investors. The organizational costs should not recompense the fund sponsor for the general overhead of set-up costs associated with running the firm. It is normal to have a cap amount stated in the legal documentation which can vary considerably depending on the complexities associated with the target investor base and the target countries for investment.

TRANSACTION FEES

There are funds that charge a transaction fee – whether on acquisition or disposition of real estate assets. Funds with these types of fees are in the minority; it is normal to assume that the costs of running the portfolio including buying and selling assets are part of the base management fee outlined above.

There are distinct regional variations regarding the prevalence of transaction fees. There are many funds in Europe that have either an acquisition fee and/or disposition fee. This practice is less common in the U.S. Once again, the question is how the overall alignment of the fund incentivizes the fund sponsor and how the net-of-fee returns flow through to the end investor. As an overall comment, a transaction fee could be argued to foster churning in the portfolio, particularly on core or core-plus funds that do not have a carried-interest mechanism. This is because the fees that flow to the fund sponsor would be directly linked to how much trading it does. Further, the market has found ways to set the base management fee at an appropriate level, that when combined with appropriate carried-interest language orientates the fund sponsor to focus on generating returns to the investor irrespective of the amount of transactional activity it does.

Sponsor commitment

Strong alignment comes from those funds where the fund sponsor has committed capital to the fund. Since the global financial crisis, the market has increasingly focused on the quality as well as quantity of the sponsor commitment. Small start-up firms will normally have less personal capital to commit to their funds. Larger established firms may have eye-catching amounts of capital committed to their own funds. In each case, investors can make their own judgments, which should often be made alongside how the carried interest is allocated to the team and the vesting schedules associated with any payments.

The market has also witnessed large sponsor commitments from parent companies, even if the team on the ground tasked with generating returns does not have appropriate incentives in place that are aligned with investors. Another way for sponsors to incentivize the team of individuals working on the fund is to offer loans (either recourse or non-recourse). While nothing substitutes for ‘skin in the game’ (that is, personal equity), schemes involving fund sponsors lending to individuals should be looked at closely. In theory, it can offer strong alignment. But it can – and has – meant personal over leverage, in some cases. It can also lead to challenges in a workout situation on a fund where an individual is not being incentivized to chase after the last dollar because its company loan is non-recourse. It is preferable to look closely at the nature of the sponsor commitment and right size it to the key investment professionals and their personal backgrounds.
Total expense ratio (TER)

The TER is sometimes called the ‘total fee load’. There is no one standard global definition of total expense ratio. For most funds, a simple comparison of the gross-of-fee return (including leverage) to the net-of-fee return (including leverage) would provide an indication of the total fees that would be paid to the fund sponsor. TERs can be historic or forward-looking based on cash-flow projections with a number of specific assumptions on when the profits are made. Either way, it is preferable to analyze the impact of the total fee load under a range of possible returns. For example, an opportunity fund that hits its target return of 20 percent gross IRR might have a net IRR of 15 percent (that is, a total fee load of 5 percent). However, if a return of 18 percent is met, then the fee load might still be close to 5 percent. Then, at a gross IRR of 15 percent, the fee load is 4 percent. Catch-up provisions can skew the fee load considerably, in addition to the overall preferred return and base management fee.

Bid-offer spreads and ‘at NAV’ priced funds

Many open-ended funds investing in Europe have an issue that is not significant in other countries like the U.S. Investing in European real estate comes with high costs called stamp duty land tax (SDLT) or transfer costs that are paid to the government on the acquisition of real estate assets. Although most investors look to minimize this tax leakage through innovative structuring, it is generally difficult to bring the tax leakage down to an insignificant level when investing in pan-European real estate. As an example, the SDLT paid to the UK government when buying UK real estate is as follows:

Figure 3:

<table>
<thead>
<tr>
<th>Purchase price</th>
<th>Stamp duty land tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to £150,000</td>
<td>Zero</td>
</tr>
<tr>
<td>Over £150,000 to £250,000</td>
<td>1%</td>
</tr>
<tr>
<td>Over £250,000 to £500,000</td>
<td>3%</td>
</tr>
<tr>
<td>Over £500,000</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: HM Revenue & Customs, 2011.

This high cost of acquiring real estate assets produces an issue when running an open-ended fund. The issue is that the incoming investor is buying into a portfolio of assets which have already been ‘written down’ in terms of SDLT. To take an example, investor A seeds a fund that invests $100 million into real estate. The SDLT paid to the government might be $5 million so that the investor has borne $105 million in terms of total outlay in order to get exposure to $100 million of assets (the market would only pay $100 million as that is the intrinsic value of the real estate). Investor B, who looks to enter the fund subsequent to Investor A, would be advantaged if it invested at $100 million as it would not have borne the costs of acquiring the portfolio. Similarly Investor A would be disadvantaged as it had invested the extra $5 million which is benefitting Investor B. The market has found two ways around this issue. One way is to operate a bid-offer spread where the offer price is set at a level that equates to the SDLT associated with the investment. In our example, the offer rate would be 5 percent above the mid-price, that is, $5 million on the $100 million portfolio. The bid price is to cover the costs of selling the portfolio – but this is a smaller issue compared with the costs of acquiring the portfolio.

Another method is to accrue the acquisition cost over a period of years (say five) and for the NAV to reflect that accrual method. Investors entering or exiting the fund trade at NAV. The logic of this is that the acquisition cost is smoothed to allow investors not to be hit with a write-down on day 1 (effectively absorbing the $5 million in our example above). Assuming the fund is of critical size, and that investors generally do not overly trade their exposure to the fund, this approach can work. Some funds that operate this at-NAV approach also
combine it with a lock-in period that ties the investor to the fund for a number of years (anything from two to five years is typical). From an investor’s perspective it is preferable to buy in at NAV and to avoid a day 1 write-down of $5 million using the example above. However, the complexity is acute for open-ended funds that are in their start-up phase. Again, a lock-in period is a potential way around the issue.

**Right of first refusal (ROFR)**

The ROFR is a mechanism whereby existing investors in a fund have a right to refuse an offer that an existing investor has received from a third-party investor. In practice, this right is clearly framed as an option for the existing investors to purchase the shares of the exiting investors. The ROFR process is normally very strict in terms of the time existing investors can exercise their option and execute the transaction. In practice, not all funds have ROFRs in place, but most do. As long as there are strict procedures surrounding the ROFR, it should work smoothly for both fund sponsor and investors alike.

**Conclusion**

This article has highlighted and explained the key economic terms in private real estate funds. Given the thousands of funds launched over the past decade, it is difficult to generalize in terms of what is the market norm, or even best practice, as it relates to specific individual terms and clauses. However, the market is keenly aware of getting strong alignment between fund sponsor and investors alike. While a holistic approach is advisable – to examine all fund terms together – it should be appreciated that it is necessary to pour over the details of specific fund terms in order to make that holistic judgment call.
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