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Creatively Completing the Capital Stack: Real Estate GP Private Equity Funds

Structuring Key Deal Terms Regarding Distribution, Sharing of Promote and Fee Income, Capital Contributions, Distributions, and More

THURSDAY, JULY 20, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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CREATIVELY COMPLETING THE CAPITAL STACK: THE RISE OF REAL ESTATE "GP" FUNDS

Strafford National Webinar

July 20, 2017

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A NEW AND CREATIVE SOURCE OF CAPITAL

- As the **real estate boom** reaches new heights, real estate private equity sponsors are becoming **increasingly capital constrained**.
- The traditional real estate private equity structure requires that **sponsors provide a substantial portion of the equity capital** (up to 20%) used to acquire and develop properties – this is the "sponsor equity".
- However, **successful real estate PE sponsors** often have **more opportunities available to them than they can pursue** because their personal capital is already committed to other real estate PE projects.
- **GP Funds provide some or all of the sponsor equity** for real estate investment vehicles, instead of the sponsor providing all of that equity.
- GP funds can provide sponsors with a **new and creative way** to complete their capital stacks, but can also **raise fundamental issues concerning the allocation of risk and reward** between the sponsor and the outside investors.

TYPICALLY SINGLE PROPERTY JOINT VENTURES

Real estate investment vehicles are typically structured as **single-property joint ventures**:

- The sponsor identifies a **single property** to acquire and develop or reposition.
- A **joint venture entity** – typically an LLC or an LP – is formed for the project.
- The sponsor provides the **"sponsor equity"** portion of the total equity capital required for the project.
- **Institutional investors** – typically insurance companies and other institutional investors – provide the **balance of the total equity capital** required for the project, which is typically **pari passu with the sponsor equity.**
- A bank or other lender provides the **debt financing for the project**, typically structured as mortgage debt that is secured by a first lien on the property.
- **Investor authorization** is required for the JV's acquisition of the property, which is typically done through a **single member LLC** wholly-owned by the JV.

SKIN IN THE GAME

- Although outside investors typically have sufficient capital to be able to fund all of the equity capital required for the JV, they often **require the sponsor to make meaningful equity contributions** in their JVs.
- Investors say that **sponsors having their own capital at risk** in investments made by the JV **gives the sponsor "skin in the game"**.
- Losses incurred by the JV result in the **sponsor losing its own capital**, along with the capital of the outside investors, **aligning the interests** of the sponsor and the outside investors.
- Helps **mitigate the risk** of the sponsor making **unwise decisions** concerning the investment and **further incentivizes the sponsor** to make **successful investments**.

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OTHER INCENTIVES

- Sponsors often respond **that they have other incentives** to make successful investments and not make unwise investment decisions, including:
  - → **Reputational damage** and **inability to raise subsequent equity capital**.
  - → Since the vast majority of sponsors' overall compensation occurs through the "promote," **poor performance means working for free**.
  - → The **sponsor's capital contribution to the GP fund** – 5-10% of the fund's capital – is often a **substantial portion of the sponsor's net worth**.
- The practical reality for **successful sponsors** is that, due to their **success in sourcing multiple attractive real estate opportunities** and the **"back-end" nature** of their promote income from other JVs, **sponsors are often capital-constrained**.
- Successful sponsors have **more opportunities available to them than can be pursued** if they are required to contribute **substantial sponsor equity** to all of their JVs.

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AN ATTRACTIVE INVESTMENT OPPORTUNITY

- **Investing in a GP fund**, rather than in the underlying JV, can be attractive to investors because **GP funds typically offer investors greater financial return potential**.
- That is the case because the sponsor typically receives a **larger percentage of the JV's profits relative to the amount invested** as compared to the outside investors.
- The larger percentage of profits is due to the **sponsor also providing the "sweat equity" of sourcing and managing** the JV's investments.
- Sponsors raising GP funds are essentially **monetizing their sweat equity** by **substituting outside investors' capital for their own** capital in satisfaction of their sponsor equity contribution obligations to their JVs.

THRESHOLD ISSUE

- A **threshold issue** for sponsors considering using a GP fund is ensuring that the outside **investors in the underlying JVs are comfortable** with a portion of the sponsor equity **coming from other investors**, rather than all from the sponsor's own funds.
- As discussed above, some outside investors **require the sponsor to have "skin in the game"** by investing a substantial amount of sponsor's own funds in the underlying JV. This is **less important** to other outside investors.
- Since the **source of the capital** used by the sponsor to make its equity contribution to the JV is **material information** to the investment decisions of investors in that JV, **use of a GP fund should be disclosed to JV investors** in the investment documents.
- This disclosure can lead to **difficult discussions** between the sponsor and the JV investors as it can raise **fundamental questions of risk and reward**.

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KEY DEAL TERMS – DISTRIBUTION STRUCTURE

- Since GP funds are relatively new, they **do not yet have an established body of "market" deal terms**. The terms of GP funds can vary significantly depending on the **relative negotiating strength** of the sponsor and the GP fund investors, as well as other factors.
- However, some **common GP fund deal terms** have emerged…
- ***Distribution Structure*:**
  - → GP funds typically employ the **customary private equity fund distribution structure** in which the investors receive back their invested capital, plus a preferred return on that invested capital, and any remaining profits are divided between the outside investors and the sponsor according to an **agreed-upon split ratio.**
  - → The **outside investor/sponsor profit split ratio sometimes changes** in favor of the sponsor as successively higher **internal rate of return (IRR) hurdles** are reached.

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KEY DEAL TERMS – DISTRIBUTION STRUCTURE

- ***Distribution Structure (cont.)***
  - → Sometimes, once the outside investors receive their preferred return, there is a **"catch up"** so that the sponsor ultimately receives the **agreed-upon percentage** of the GP fund's total profits.
  - → The **profit split** among the sponsor and the GP fund investors may be determined on an **investment-by-investment** basis or on an **aggregate basis** for all underlying JV investments.
  - → Since **GP fund investors typically participate in all or a portion of the promote** paid by the underlying JVs (as described below), the GP fund's profit split often **exceeds the standard 20% for the sponsor**.

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KEY DEAL TERMS – SHARING THE JV PROMOTE

- ***Variations on Sharing of the Promote from the JV Investor***
  - → In some GP funds, the investors are entitled to the proceeds received from the underlying JVs attributable to their invested capital, but **do not share in promote payments** from the underlying JVs.
  - → However, GP fund investors **more commonly receive all or a portion** of the underlying JVs' **promote payments**.
  - → The rationale is that, without sharing in the promote, **they would not have any incremental economic benefit**, as compared to investing directly in the underlying JVs.
  - → However, GP fund investors still receive the **benefits of diversification**, the ability to participate in **real estate investments to which they would otherwise not have access**, and **access to underwriting** of those investments by both the sponsor and sophisticated institutional investors.

KEY DEAL TERMS – SHARING OF PROPERTY LEVEL FEE INCOME

- ***Sharing of Fee Income***

→ GP funds typically **do not share in fee income** received by affiliates of the sponsor for **ancillary services** to the underlying JVs, such as:

- development fees
- property management fees
- leasing fees
- construction management fees
- financing fees

→ That is the case because such fee income is often **attributable to discrete services** being provided by the sponsor affiliates that **would otherwise be provided by third parties** to the underlying JVs, **typically at market rates**.

KEY DEAL TERMS – MANAGEMENT FEES

- ***Management Fees***
  - → Sponsors of GP funds that invest in **more than one** underlying JV **typically receive management fees** (either directly or through an affiliated management company) similar to other types of private equity funds.
  - → As is the case for other types of private equity funds, the management fees of GP funds are typically calculated as a **percentage of the fund's total capital commitments** until the end of its investment period and a **percentage of the fund's total invested capital** for the remainder of its term (the percentage typically ranges from 1.5 to 2%).
  - → Sponsors of GP funds that invest in a **single underlying JV** may also receive management fees from the GP funds, which may be based on the amount invested and may be **paid periodically** or as a **one-time fee** upon closing the investment.

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KEY DEAL TERMS – DECISION MAKING RIGHTS

- ***No Investment Decision-Making Rights***
  - → Although the GP fund investors are investing in the entity that makes the investment decisions for the underlying JVs, they are **typically passive investors that do not participate in that decision-making process**.
  - → That is the case because any such involvement would likely raise **issues with the underlying JVs' investors**, which premised their decisions to invest in the JVs based on the sponsor's **track record, judgment** and **investing acumen**. The underlying JVs' investors would not welcome what they would likely view as **interference from the GP fund's investors** in the **decision-making** process.
  - → The underlying JVs' investors, particularly if they are institutional investors, **typically have substantial veto rights relating to the investment** and often can **unilaterally force a sale of the property or a buy-sell process**, which is a **risk factor that must be disclosed** to the GP fund's investors.

KEY DEAL TERMS –CONTRIBUTIONS AND DISTRIBUTIONS

- ***Timing of Capital Contributions and Distributions***
  - → GP fund capital contributions and distributions typically **correspond to those of the underlying JVs**.
  - → The GP fund's **commitment period matches** those of the underlying JVs, so the **GP fund can call capital from its investors** when the **underlying JVs call capital** from the sponsor.
  - → GP fund investors are typically **required to fund their capital contributions** to the GP fund **within the time period** in which the sponsor is required to make its **sponsor equity contributions** to the underlying JVs.
  - → GP funds typically also make **capital calls** to cover any **GP fund-level expenses not satisfied out of distributions** received by the GP fund from the underlying JVs.
  - → Subject to **holdbacks to cover GP fund-level expenses**, whether directly or to replenish reserves, distributions are typically made by the GP fund to its investors within **a short time after the GP fund receives distributions** from the underlying JVs.

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KEY DEAL TERMS –DEBT GUARANTEE OBLIGATIONS

- ***Sponsor Debt Guarantee and Cost Overrun Obligations***
  - → Investors in GP funds are usually not responsible for any of the **"nonrecourse carveout"** and/or **"completion" guarantees** provided by sponsors to lenders in connection with debt financings obtained by the underlying JVs.
  - → Sometimes, sponsors are able to persuade their lenders to **accept the GP fund as the guarantor of those obligations**, rather than the sponsor entity or its principals providing the guarantees.
  - → The rationale is that the GP fund, through its capital commitments, may have **more substantial financial resources** than the sponsor and its principals.
  - → Sometimes, GP fund investors **do not want** the GP fund to provide investment-level **debt guarantees** because that otherwise **cross-collateralizes** GP fund investments.
  - → **GP fund investors not being responsible for debt guarantee or cost overrun obligations** is sometimes cited by sponsors as being part of the **rationale for the GP fund not sharing with the GP fund investors** all or part of the **promote payments** received from the underlying JVs.

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KEY DEAL TERMS –INFORMATION RIGHTS

- ***Information Rights***
  - → GP funds typically provide their investors with **reporting similar to other private equity funds**.
  - → GP fund investors typically receive:
    - Quarterly and annual **GP fund-level financial statements**
    - Quarterly and annual **summary reports** on each of the underlying JVs, but **typically not property or JV-level reports**.
  - → The sponsor sometimes needs to obtain the **approval of the outside investors** in the underlying JVs to provide such **investment-specific information** to the GP fund investors.

OTHER KEY DEAL TERMS

- ***Term; Liquidation Rights***
  - → The **term of the GP fund** must cover the **expected holding period** of the underlying real estate investment or the sponsor must **negotiate the right to liquidate** the GP fund's investment in the JVs.
- ***Investment Limitations***
  - → The GP fund typically has **diversification** and **leverage limitations** similar to those of a private equity fund.
- ***Investment Allocation***
  - → The sponsor is typically required to **allocate investment opportunities** to the GP fund that **best fit its investment criteria** during the GP fund's investment period.

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OTHER KEY DEAL TERMS

- ***Divorce Clauses***
  - → Typically, the **sponsor of the GP fund can only be removed for "cause".** "No fault divorce" removal of the sponsor is typically <u>not</u> allowed and "cause" threshold is high because **institutional investors** in the underlying JVs **require continued sponsor involvement**.
- ***Regulatory Compliance***
  - → Like private equity funds, GP funds are required to **comply with federal and state securities laws**:
    - The Securities Act of 1933
    - State Blue Sky laws
    - The Investment Advisers Act of 1940
    - The Investment Company Act of 1940

THANK YOU!

Questions?

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