

# Creating a Private Equity Fund: A Guide for Real Estate Professionals

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## About NAIOP

NAIOP, the Commercial Real Estate Development Association, is the leading organization for developers, owners and related professionals in office, industrial, retail and mixed-use real estate. NAIOP comprises some 19,000 members in North America. NAIOP advances responsible commercial real estate development and advocates for effective public policy. For more information, visit [naiop.org](http://naiop.org).

The NAIOP Research Foundation was established in 2000 as a 501(c)(3) organization to support the work of individuals and organizations engaged in real estate development, investment and operations. The Foundation's core purpose is to provide information about how real properties, especially office, industrial and mixed-use properties, impact and benefit communities throughout North America. The initial funding for the Research Foundation was underwritten by NAIOP and its Founding Governors with an endowment established to support future research. For more information, visit [naiop.org/research](http://naiop.org/research).

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## Disclaimer

This project is intended to provide information and insight to industry practitioners and does not constitute advice or recommendations. NAIOP disclaims any liability for action taken as a result of this project and its findings.

# Executive Summary

Setting up a private equity fund can be a big and confusing step for many real estate professionals. To help demystify private equity fund formation and operation, the NAIOP Research Foundation commissioned this white paper. It is geared toward those who have limited familiarity with the process and want to learn the basics. The authors provide step-by-step guidance, along with an example of a fund waterfall and a case study of how one company successfully used a series of private equity funds to seek out opportunities during the financial crisis when other sources of funds were limited.

The real estate private equity fund industry has grown into a multi-billion-dollar global business. However, scale is not necessary to be successful; smaller fund managers can create value and returns for all parties involved. Real estate funds can allow sponsors (managers) to diversify and expand funding sources, invest in larger, higher-quality projects, obtain better terms from banks, and earn fees from the fund, including promoted interest.

Fund managers must go into the endeavor prepared. They must consider the amount of equity capital to be raised, including fees; be aware of the amount of time required to launch and maintain the fund; and have a clearly articulated investment fund strategy. The five main investment fund strategies range from low risk/return to high/risk return. In that order, they are: core; core-plus; value-add; opportunity; and distressed debt/mezzanine.

Sponsors typically collect compensation through promoted interest and an assortment of fees. However, sponsors should not see their fund as a vehicle for generating fees at the expense of their investors. In addition, and as this paper details, sponsors should also be aware of securities laws and other regulations, and how to properly produce offering materials.

After sponsors have cleared the hurdles of the initial fund set-up, they must be prepared to properly govern and operate it. These operations include the formation of an investment advisory committee and a plan for the distribution of the returns, as well as the consideration of clawbacks, which are found in some funds with multiple investments and allow investors to receive funds if later marginal investment results in an over-allocation of profits to the sponsors.

The most important aspects of setting up a private equity fund, no matter the strategy, are to have solid, trustworthy fund leadership and a transparent communication style. The fund manager's reputation is essential to attracting investors and successfully managing the risks and rewards. A well-managed and successful fund is not only an effective tool in leveraging investment — it can also attract broader business opportunities in the future.

# Introduction

The NAIOP Research Foundation commissioned this paper for real estate professionals involved in the creation and operation of private equity real estate funds, as well as for accredited and non-accredited investors seeking a step-by-step understanding of the structure and returns associated with this type of investment.

With increasing capital flows into the real estate industry, real estate-focused private equity funds are an important tool for the growth of firms. Historically, access to funds has been limited to large firms that have relationships with major commercial and investment banks. This has changed as many small- and medium-sized firms have increased their ability to market their funds to qualified investors directly.

These direct-to-investor vehicles can be created on a deal-by-deal basis or for small portfolios of multiple properties. The classic offering is a \$50 million to \$150 million fund with a focused strategy to develop or acquire several properties according to clearly defined goals.

While private capital is often raised to make loans to real property, these private debt offerings are beyond the scope of this report. Instead, this white paper outlines the steps real estate professionals need to take to structure, market and administer an equity fund, all based on best practices identified in the literature and interviews with industry experts. It is based on the authors' two-part series published in NAIOP's Development magazine (2018) entitled "Setting Up Your First Investment Fund."

Real estate capital markets are classically described as being comprised of "Four Quadrants"<sup>1</sup> as shown in Figure 1. This paper focuses on the upper right quadrant, private equity capital that provides significant liquidity and depth to the capital markets. With approximately 28 percent market share (70 percent private multiplied by 40 percent equity), private equity is a significant and important source of equity capital in the United States.

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<sup>1</sup> Widely attributed to Gordon, Jacques. "The Real Estate Capital Markets Matrix: A Paradigm Approach." Real Estate Finance 11.3 (1994): 7-15.

Figure 1  
**The Four Quadrants of Real Estate Capital Markets with Stylized Market Shares**

Real Estate Capital Markets		Capital Stack Positioning	
		Debt (60 percent)	Equity (40 percent)
Source of Capital	Private Market (70 percent)	<b>Private Debt</b> Commercial Banks Debt Funds	<b>Private Equity</b> Equity Funds Direct Investment
	Public Market (30 percent)	<b>Public Debt</b> Commercial Mortgage-Backed Securities Business Development Companies Mortgage REITs	<b>Public Equity</b> Equity REITs Real Estate Operating Companies

In its simplest form, a real estate private equity fund is a partnership established to raise equity for ongoing real estate investment. A general partner (GP), henceforth referred to as the sponsor, creates the fund. The sponsor asks investors, known as limited partners (LPs), to invest equity in the partnership. Those funds, along with money borrowed from banks and other lenders, will be invested in real estate development or acquisition opportunities.

A real estate private equity fund differs from the capital that comes from friends and family or from joint ventures. Investments by friends and family are generally not subject to an extensive partnership agreement, and each dollar of equity investment is usually treated equally. Joint ventures are set up for a specific purpose on a single investment wherein each partner adds specific value to the investment. Real estate private equity funds, on the other hand, are created to invest in one or more real estate deals with a risk-and-reward structure in which the sponsor and LP participate unequally; in exchange for taking more risk, the sponsor achieves potentially higher rewards.

Typically, the LPs provide the bulk of the equity capital and are passive investors who have chosen to invest in an offering presented by the sponsor. LPs earn an early return of capital and a preferred return on capital invested.

Sponsors provide some of the equity capital; develop or acquire the real estate; manage the real estate and the fund; receive fees for providing services to the fund; and get a success fee once the LP earns returns in excess of stated hurdles, called a promoted interest or “promote.”

The real estate equity fund industry has developed into an industry in which the top 50 global firms each raised more than \$2 billion in the past five years, according to the PERE 50 report. However, this scale is not necessary to be successful; a smaller sponsor can create funds on a deal-by-deal basis or for small portfolios and still provide a meaningful and compelling story for creating value and returns to the sponsor and LPs.

While motivations may differ among sponsors, the private equity fund structure can provide significant rewards when properly executed. The key is to have a clear strategy for creating the fund and then executing against that strategy. Real estate funds allow the sponsor to accomplish the following:

- Diversify and expand funding sources.
- Invest in larger, higher-quality projects.
- Diversify holdings to reduce risk.
- Obtain better terms from banks and other lenders.
- Provide an alternative to mezzanine capital.
- Acquire and develop projects using fund-level financing in lieu of project-by-project financing.
- Earn fees from the fund, including a promoted interest.

# Three Key Considerations

While there are many factors to take into account when setting up a fund, there are three key considerations needed to successfully establish the fund and efficiently raise capital from the limited partners.

**The first consideration is the amount of equity capital to be raised, including organizational fees.** The minimum fund size is generally considered to be \$20 million, although crowdfunding platforms have reduced this in some cases. While organizational costs are proportional to fund size, the lower floor for organizational fees is about \$400,000. Although the sponsor can recoup these fees from the fund once the capital is raised, the sponsor must carry these costs during the formation period. These include formation costs for the legal entity or entities, filing fees, accounting fees, regulatory brokerage costs, clearing costs and the cost of producing marketing documents.

While the fund's equity capital will be combined with debt capital to create the total pool for investing, a well-executed fund needs to balance potential deal flow with fund size to ensure that the fund can produce sustainable returns for the LPs, and that it is not so small that a follow-on fund needs to be launched. The timing of flows to and from the fund also must be considered. Typically, LPs start earning a preferred return on their capital as soon as the funds are invested. Thus, in addition to obtaining a commitment from each LP for the total amount invested, wise sponsors stage the pay-in to match the anticipated timing of investment outflows.

**Second, sponsors must be realistic about the amount of time, energy and seed funding required to launch a fund.** The sponsor is responsible for all aspects of the fund: managing and organizing it, which includes generating a partnership agreement; offering and subscription documents; securing investment opportunities; securing loans and other financing; operating the properties; preparing partners' tax returns; and accounting and audit matters, to name only the highlights. While many experienced real estate firms perform the majority of these activities in the course of their existing businesses, in a private equity fund environment the sponsor is governed by the strict nature of the partnership documents and offering memorandum, so attention to detail is paramount. Also, the fund structure will require that the sponsor establish regular, organized meetings with the LPs and a consistent reporting structure, a task increasingly facilitated by software.

**Third, sponsors must have a clear investment fund strategy, generally one of the five strategies outlined in the next section.** The strategy is distinct from the market fundamentals, property type and location strategies that dominate the traditional real estate investment assessment. While experienced sponsors and the largest funds may be able to raise funds for a blind pool — a fund for which no individual investments are identified — first-time sponsors must identify specific investments that are included in the fund's offering memorandum.

# Five Fund Strategies

Sponsors should be clear about the fund's strategy — most importantly, where the fund will operate on the risk/return continuum — and stay true to that goal. The private equity industry has sorted itself into five different types of funds, listed below in order of risks and returns. The metrics that LPs concentrate on include returns, equity multiples and sheltered income. Returns include the cash-on-cash returns and the net LP internal rate of return (IRR).

**Core.** This type of fund has the lowest risks/rewards. It typically offers 6 to 8 percent net equity IRR to LPs; no/low leverage; and well-occupied, stable, high-quality assets in primary markets and locations. The fund's returns are dominated by the annual income return, not appreciation.

**Core-plus.** This type of fund contains high-quality assets in secondary markets/locations or slightly risky assets in primary markets/locations. It offers 8 to 12 percent net equity IRR to LPs. Moderate leverage — up to 50 percent — is employed to increase equity IRR. This fund offers a relatively high annual income return, with only a fraction of the returns coming from appreciation.

**Value-add.** These funds contain assets improved via re-leasing, operational efficiencies and/or redevelopment; they also include new development. They employ moderate leverage, up to 70 percent. Market/location is secondary to the opportunity to add value. Appreciation is a significant part of the overall investment returns. These funds offer 11 to 15 percent net equity IRR to LPs.

**Opportunity.** These funds offer high risks/returns. They involve repositioning and redeveloping poorly operated, vacant or outdated buildings or investing in infill opportunities that others miss. Market/location is secondary to the opportunity. Appreciation dominates the returns, with much of the return occurring at the end of the holding period. These funds typically seek to offer more than 15 percent net equity IRR to LPs.

**Distressed debt/mezzanine.** These funds purchase senior loans, mezzanine loans or nonrated commercial mortgage-backed securities (CMBS) tranches, or make mezzanine loans. They use leverage to increase equity IRR and are not averse to owning if loans default. They offer 8 to 12 percent net equity IRR to LPs, with some uncertainty about the timing of the cash flows. While performing loans provide steady cash flows, non-performing loans must be converted to equity via foreclosure and then harvested by property operation or property sales.

Sponsors need to clearly articulate their fund's strategy and then make investments that are consistent with that strategy. The LPs seek returns in exchange for tying up their funds for several years with little control over the operation of the fund. Sponsors who can answer specific questions about the timing and magnitude of LP returns are more successful at raising capital than those who cannot. Most sponsors can create a fund only after they have demonstrated success, which often includes ownership of a healthy portfolio.

**Best Practice:** An excellent strategy for a sponsor with an existing portfolio is to create two funds: a core-plus fund of existing stable assets created from the sponsor's existing portfolio that can deliver immediate returns to investors and is a viable exit strategy for the sponsor, and a value-add fund to provide capital for the sponsor's development and acquisition opportunities. The sponsor thus has two clear strategies and two different risk/return opportunities for potential investors, who can choose between the two funds or can invest various amounts of capital in each, depending on their needs.

# Sponsor Compensation

Sponsors must carefully consider their compensation and align their interests with those of their LPs. Sponsor compensation may come from two sources:

**1. The Promoted Interest.** Also known as the “promote” or “carried interest,” this generally consists of a 2 percent fee based on capital raised from the LPs and 20 percent of the profits of the fund. In some cases, to align the interests of the sponsor and the LPs, the sponsor receives only those profits remaining after the LP investors have earned their preferred return.

**2. Fees.** Sponsors may earn fees for a variety of services provided to the fund. These are listed below, with ranges and commentary from NAIOP Forum members<sup>2</sup>:

- **Fundraising fees** for organizing the fund, preparing the offering and fund-governing documents, and soliciting contributions. These fees are in the range of 0.5 to 2 percent of equity raised. Sponsors involved in their first fund are often asked to waive this fee or deduct it against actual costs incurred.
- **Acquisition or disposition fees** for transacting on behalf of the fund, typically 0.5 to 1 percent of the acquisition price. These fees are controversial; many LPs will ask for them to be deducted against the promote or will ask sponsors to waive them.
- **Asset management fees** for managing the fund on behalf of investors — distributions, tax returns and financial statements, for example. These fees are generally 1.5 percent of the value of assets under management on an annual basis. First fund sponsors may be asked to consider fees based on the equity capital balance, not assets under management.
- **Finance and guarantee fees**, for securing loans and providing a bank guarantee on behalf of the fund, generally 0.5 to 1 percent of funds secured or guaranteed. Finance fees are one-time fees, while guarantee fees are earned annually for the life of the guarantee. Finance fees are hard to obtain for first fund sponsors, so many LPs will ask for them to be waived. While it seems obvious that a guarantor must be able to stand by any guarantee, LPs openly worry about the quality of guarantees from thinly capitalized sponsors.
- **Property management, leasing, construction and development fees**, when the sponsor provides these services in lieu of hiring an outside firm; these fees typically are based on market norms. Sponsors should expect to defend these fees, be able to clearly explain their expertise, and articulate why their firm dominates non-affiliated competitive service providers.

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<sup>2</sup> A summary of findings was presented at the October 2018 CRE.Converge event. Commentary from those Forum meetings has been incorporated.

Sponsors should not see their fund as a vehicle for generating fees at the expense of the LPs; this approach is a sure route to an unsuccessful fund. On the other hand, a sponsor that can add value in the capital markets, development, acquisition and property management functions via superior management, local market knowledge and depth of experience should be willing to incorporate fees relating to these services into the fund structure — as long as the fees are necessary and reflect industry norms.

**Best Practice:** A litmus test for fee inclusion is whether the sponsor would be willing to pay them if it were an LP in the fund. Sponsors should be able and willing to demonstrate that it is the promoted interest — specifically, the participation in profits after the LPs have their preferred return — that drives their decision-making and aligns their interests. Further, sponsors should be transparent about the overall returns to the fund both before and after fees, as well as the gross and net IRRs to the LP investors.

# Securities Laws, Regulation D and the Offering Memorandum

This section reviews the securities laws that govern private equity funds, explores the most common offering terms and discusses fund operations. It is not intended to be an exhaustive review of private placements or securities laws.

Note that any firm contemplating the creation of an investment fund should retain legal counsel and an experienced financial team to assist with the process of raising and administering the fund. Commonly sponsors also work with placement agents. These are intermediaries who advise and assist in setting up funds and raising money from investors, particularly if the sponsor is looking to raise equity beyond a narrow network of investors.

The creation of an investment fund using a private equity offering can be accomplished without registering with the Securities and Exchange Commission (SEC), as long as the offering conforms to the requirements of Regulation D of the Securities Act of 1933. The act has been updated over time; this paper refers to the current rules. These were most notably revised by the JOBS Act of 2012, which eased various securities regulations to encourage funding of small businesses. They were further refined by amendments in 2016 that revised the rules governing exemptions for registration.

**Regulation D** establishes two exemptions from the registration requirements of the Securities Act, Rules 504 and 506. Regulation D also establishes two fundamental types of investors: “accredited investors” and “non-accredited investors.” Accredited investors are those with a personal net worth in excess of \$1 million, excluding the value of their home (individually or jointly with their spouse), or those with annual income in excess of \$200,000 in the past two years and a reasonable expectation of the same in the current year (\$300,000 jointly with their spouse). Also, directors, executive officers and general partners of the sponsor and business entities are considered accredited investors. If any of those criteria are not met, investors are considered non-accredited regardless of their income or net worth.

**Rule 504** allows sponsors to raise up to \$5 million annually without SEC registration. Funds can come from any number of investors, accredited or non-accredited, and the sponsor is not subject to any specific disclosure requirements. The investment offering is “restricted” in that interests granted to investors may not be sold without registration. Although Rule 504 provides an exemption from federal SEC registration, sponsors must comply with state-level securities regulations designed to protect investors against fraudulent sales practices and activities; these are known as “blue sky laws.”

Under Rule 504, sponsors are not generally allowed to solicit or advertise the offering of interests to the public, but the rule may allow those activities if specific requirements are met. Most notably, sponsors who follow state securities law exemptions, called the Small Corporate Offering Registration (SCOR), may advertise the offering provided that the sponsor sells interests only to accredited investors. While Rule 504 allows for the sale of interests without specific disclosure requirements, sponsors should be mindful of antifraud provisions that require any information provided to be free of false or misleading statements.

**Rule 506** allows sponsors to raise unlimited funds as long as they follow a specific set of standards, which fall under two broad categories — Rule 506(b) and Rule 506(c).

Under Rule 506(b):

- The sponsor can offer the fund to an unlimited number of accredited and up to 35 non-accredited investors. All non-accredited investors must be sophisticated or be advised by an investment adviser who is. The SEC defines a sophisticated investor as someone with sufficient knowledge and experience in financial and business matters who is capable of evaluating the merits and risks of the prospective investment.
- There are no specific rules for disclosure to accredited investors, but the sponsor must make significant disclosures to non-accredited investors that are generally the same as those for registered offerings, including financial statements. Any information provided to accredited investors must be made available to non-accredited investors.
- The sponsor must be able to answer questions from prospective purchasers.
- The sponsor may not solicit investors or advertise the offering.

Under Rule 506(c), a company may solicit investors and advertise the offering, provided that:

- All investors in the fund are accredited.
- The sponsor takes reasonable steps to verify that investors are indeed accredited beyond receiving a statement by the investor — for example, reviewing tax returns, bank or brokerage statements and similar documents.
- Investors do not sell their interests for at least one year.

Regardless of the rule used to offer interests, sponsors must be aware of four items that affect all private placements: Sponsors are required to file with the SEC within 15 days of the first sale of an interest; sponsors must not violate the antifraud provisions of federal securities laws; sponsors cannot “game the system” by creating multiple offerings that are essentially the same; and state laws (e.g., blue sky laws) must be followed.

**Offering Materials and the Private Placement Memorandum.** While offering materials are sometimes mandated, as detailed above, sponsors must view the offering materials or private placement memorandum (PPM) as an effective and positive communication medium as well as a way to protect the sponsor from unforeseen liability. Sponsors of interests offered via Rule 504 or Rule 506(b) are often dissuaded from issuing a PPM because it is expensive to produce and not required as long as one is making an offer only to accredited investors. The costs range from \$25,000 to \$250,000, so the decision to prepare a PPM is not to be taken lightly.

If only a small number of accredited investors will be involved, the offering materials can consist of a term sheet and a willingness to allow the investors (usually as a group) to perform due diligence on the offering. When the number of potential investors is large or the offering is large, a formal PPM can help the sponsor effectively communicate a consistent offering to investors, help investors understand the rewards and risks of investing, and protect the sponsor from possible anti-fraud charges.

Appendix I provides an example of the principal terms for the first fund.

# Fund Governance

The beauty of the private governance model is that the managers of the fund are also investors; their potential equity claims cause their interests to be aligned with the majority investors (the limited partners). The sponsor, as manager of the private equity fund, is an “activist investor” in the best sense; sponsors are rewarded for seeking to continually unlock value via active control of strategy and execution, similar to activist investors who seek control of public company boards. With compensation tied to investment performance, sponsors are motivated to create value. These motivations allow sponsors to act independently with limited oversight. The private equity model does not mean that there is no need for oversight or a formal governance structure. Sponsors should have a governance structure that recognizes the need for transparency in an environment where the sponsor has broad discretion over decision-making. The opening paragraph of the governance section of the Institutional Limited Partners Association (ILPA) “Private Equity Principles 2.0” is instructive:

*“The vast majority of private equity funds are based on long-term, illiquid structures where the [sponsor] maintains sole investment discretion. LPs agree to such structures based on their confidence in a defined set of investment professionals and an understanding of the strategy and parameters for the investments.”<sup>3</sup>*

The ILPA identifies five areas that are key to good fund governance; the team, the investment strategy, fiduciary duty, changes to the fund and embrace of an LP advisory committee.

**The Team.** The sponsor must show a commitment to the continuity of the sponsor’s investment team. This includes prompt reporting of changes to team personnel or individual team member commitment, and strong protections against improper behavior by key people.

**The Investment Strategy.** The sponsor must recognize that LPs make commitments to individual funds based on how that individual fund fits into the overall portfolio strategy of the LP. LPs value a clearly stated strategy coupled with effective and transparent execution of that strategy.

**Fiduciary Duty.** Quoting from the ILPA: “Given the [sponsor’s] high level of discretion regarding operation of the partnership, any provisions that allow the [sponsor] to reduce or escape its fiduciary duties in any way must be avoided ...”<sup>4</sup>

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<sup>3</sup> Institutional Limited Partners Association, “Private Equity Principles,” Version 2.0, January 2011, page 7.

<sup>4</sup> IBID, page 10.

**Changes to the Fund.** The fund's governance must be adaptable when conditions change, and it must allow the LPs to use supermajority votes (generally requiring at least 66 percent to 75 percent of LPs in favor) to suspend or terminate the commitment period, remove the sponsor or dissolve the fund.

**The LP Advisory Committee.** The complexities of running a modern fund should allow for shared communication and consultation with the LPs, who should be willing to speak with one voice to the sponsor through an LP-controlled advisory committee, especially with respect to conflicts or potential conflicts.

**Best Practice:** Fund sponsors should provide a governance structure that closely aligns with the principles championed by the ILPA. These include a willingness to embrace an LP advisory committee, to provide LPs with strong clawback rights, and to produce regular, timely and transparent financial reporting.

# Operating the Fund

When it comes to actively operating the fund, sponsors need to consider the following factors unique to funds with outside investors.

**Contributions** to real estate funds are most easily handled in a closed-end fund raised for a specific investment or investment set with a fixed number of investors. Using such a fund eliminates the need to value (appraise) the fund. Most funds set schedules for capital funding, termed “calls,” that specify the dates, amounts and terms of each round of funding. There is generally an initial contribution, with the remaining funds called as needed to fund the investment or development schedule.

**Distribution of cash flows and allocation of profits** are performed according to the information provided in the offering memorandum, which generally consists of a preferred return to the investors, plus the investors’ share of net profits after the preferred return. In general, investors prefer to receive their funds in the following order:

1. Investors and the sponsor receive a return of their capital contributions (which are generally not taxable).
2. Investors receive a preferred return, calculated on the basis of the total amount of capital held and the length of time those funds were held.
3. The sponsor may then receive an allocation of the profits called a “catch-up,” generally in proportion to the profit split.
4. Lastly, all remaining profits are divided between the investors and sponsor according to the agreed-upon promoted interest structure.

This structure helps align the interests of the sponsor with those of the investors.

**Clawback provisions** are found in some funds with multiple investments. They provide a vehicle for the investors to receive funds from the sponsor if a later marginal investment results in an over-allocation of profits to the sponsor, especially if the investors do not receive their entire return of capital and preferred return.

For example, imagine that a fund finds early success with its first project, placing the sponsor in the promoted interest, earning the majority of profits from the venture. However, a later project becomes distressed and needs to be sold at a loss. In this situation, a clawback provision would allow the investors to access profits from the first project to make them whole for the return of capital, preferred return or both.

**Disputes over fees and potential conflicts of interest** can arise when the sponsor is seen as profiting at the expense of the investors. While sponsors generally take a fee for managing the investments in a fund, additional fees should be handled with enough transparency to show that they are not in excess of normal market rates.

**Decision-making** is generally handled by the sponsor on such issues as budgets, purchase and sale of investments, indebtedness and leverage, use of specific service providers, and tenant selection and management. Some institutional investors may wish to participate in operational decisions and may insist on certain provisions.

**Robust internal controls** assist with timely and reliable financial reporting, help ensure compliance with internal and external regulations, and help the fund use its resources in the most effective and efficient way. A well-designed system of internal controls helps to mitigate the largest risks faced by ensuring that key controls are in place and tested regularly. The “gold standard” for internal controls is the COSO “Internal Control, Integrated Framework” by the American Institute of CPAs. This set of best practices takes an enterprise-risk-management approach to analyze financial, operational and compliance risks faced by the firm; it has been adopted by more than 60 percent of all public firms and is well aligned in a private equity setting.

**Best Practice:** Fund sponsors should provide reasonable clawback provisions in funds comprised of a portfolio of investments. LPs see this as a fundamental fairness issue because sponsors should not be able to profit from individual investments if the fund as a whole suffers. Commentary from LP investors at the CRE.Converge event clearly indicated that clawback provisions are closely examined and challenged when counter to industry norms. Appendix B in the ILPA’s “Private Equity Principles 2.0” provides guidance in this instance: “In essence, the clawback amount should be the lesser of excess carry or total carry paid, net of actually paid taxes. However, there are often errors in the stipulated formulas which have a material impact on fund cash flows: (1) The tax amount should not simply be subtracted from the amount owed under the clawback, and (2) The clawback formula should take the preferred return into account.”

# Modeling Private Equity Returns: An Example

To inspire the motivation for sponsor participation in a private equity fund, we present a simple example of a single \$20 million investment for illustration purposes. While \$20 million is small for a single fund, many sponsors have started with a portfolio of three to four \$20 million investments in a small portfolio. Below is a simple, stylized model that ignores the complexities of contemporary practice and assumes that all cash flows occur at the end of the year. The example focuses on the private equity cash flow waterfall and captures the essence in a way that is easy for any real estate professional to understand.<sup>5</sup>

**Example Setup.** To start, consider the acquisition of an industrial facility in a desirable secondary market. The building had expiring leases and was sold as a vacant building. The buyer was able to find a new single tenant prior to acquisition. Rents are fully triple net and produce a going-in cap rate of 6.35 percent.

Investment:	\$20 million (total acquisition cost)
Annual Cash Flow (NOI):	\$1.27 million in year 1, growing at 3 percent per year
Borrowing Terms:	70 percent LTV, 4.25 percent interest, no amortization (interest only)
Holding Period:	Three years
Going Out Cap Rate:	6.45 percent (10 basis points higher than the going-in cap rate)
Selling Expenses:	2 percent of gross selling price

Using this limited set of assumptions, we can easily show the expected IRR of 8.2 percent to the property investment and 16.9 percent to the equity investment (Figure 2). In addition, this structure shows an equity multiple of 1.54, meaning the equity obtains \$1.54 for each \$1 invested over the life of the investment.

<sup>5</sup> The authors are grateful for NAIOP members' comments on drafts of the example, which helps to place the assumptions and the promote structure within current industry practice.

Figure 2  
**Summary Cash Flows (CFs), Internal Rates of Return (IRR) and Overall Equity Multiple**

	Year 0	Year 1	Year 2	Year 3 (Project sold)
Overall Project CFs	(\$20,000,000)	\$1,270,000	\$1,308,100	\$22,432,739
Project IRR	8.2%			
Overall Equity and CFs –Before Fees	(\$6,000,000)	\$675,000	\$713,100	\$7,837,739
Equity IRR	16.9%			
Equity Multiple	1.54x			

**The Promote Structure.** Now consider this investment as part of a private equity fund. The sponsor will invest 20 percent of the required equity, and the LPs (known as the “Investor” in the spreadsheet) will invest the remaining 80 percent. The promote structure works in the following order:

1. The limited partner and sponsor share the net proceeds and distributable net cash flow in the ratio of 80 percent to the limited partner and 20 percent to the sponsor until both parties have received an internal rate of return of 8 percent on their invested capital and a return of their invested capital. The 8-percent figure is known as the preferred return hurdle.
2. The limited partner obtains 100 percent of net proceeds and distributable net cash flow until the limited partner has received an internal rate of return of 14 percent on the limited partner’s invested capital. This is the second LP return hurdle.
3. If the limited partner achieves an internal rate of return of 14 percent, the sponsor’s interest is promoted by 10 percent. Thus, the sponsor receives 100 percent of net proceeds and distributable net cash flow until the sponsor has received cash flows equivalent to a 30 percent/70 percent split of all second-hurdle distributions. This is one variant of a so-called “catch-up” provision prevalent in private equity.
4. If any net proceeds and distributable net cash flow remain, the sponsor’s interest is promoted by an additional 20 percent. The sponsor receives 80 percent and the limited partner receives 20 percent of any remaining net proceeds and distributable net cash flow until the final disposition of the investment.

Note that this promote structure is typical for fund sponsors who are just starting out. Unlike the top 50 real estate private equity firms, start-up sponsors generally obtain 40 to 60 percent of the cash flows after the “catch-up” provision is satisfied, not 80 percent as the top 50 firms do.

In addition, for this example we assume the sponsor takes the following fees, which are deducted before cash flows are distributed to the LPs and sponsor:

- A fundraising fee of 1 percent of all equity raised (\$60,000 at inception).
- A management fee of 1 percent of all equity raised (\$60,000 each year of operation).
- A disposition fee of 0.5 percent of the net sales price (\$105,247 at disposition/exit).

**Returns to the Investor and Sponsor.** Figure 3 shows the returns to the property investment and the total equity investment in the top panel; the equity returns are shown on a before-and after-fee basis. Below this are the returns to the LPs (called the investor in Figure 3) and to the sponsor. The sponsor returns are shown on a before-and-after-fee basis. Figure 4 shows the waterfall itself, to illustrate the manner in which these calculations are done.

First, compare the before-and-after-fee equity returns in the top panel of Figure 3. When the fees are included, the equity IRR drops by 1.8 percent, from 16.9 percent to 15.1 percent. Sponsors need to be mindful of the fees and correctly present the opportunity to the LPs on an after-fee basis. Next, examine the investor and sponsor returns in the lower panel of Figure 3. The investors obtain an overall IRR of 14.2 percent, while the sponsor obtains a return of 18.6 percent on a before-fee basis and 25.3 percent on an after-fee basis. Note the impact of the fund structure on the sponsor and the investors:

- The sponsor's equity investment is reduced from \$6 million to \$1.212 million for the same \$20 million property investment.
- The sponsor's equity IRR increases from 16.9 percent to 18.6 percent given the promote structure. Similarly, the equity multiple increases from 1.54x to 1.61x.
- The sponsor has the opportunity to earn fees for managing the investment, increasing their IRR from 18.6 percent to 25.3 percent and the equity multiple from 1.61x to 1.84x.
- LP investors have the opportunity to earn a 14.2 percent IRR, a 1.44x multiple, and a cash-on-cash return of at least 10 percent each year. The LP investors face a spread of 0.9 percent between the after-fee equity IRR of 15.4 percent and the LP equity IRR of 14.2 percent. They must decide whether the opportunity to passively participate in the anticipated returns are adequate compensation when compared with other opportunities, both active and passive.

**Figure 3**  
**Before- and After-Fee Equity Cash Flows and Returns to the Investor and Sponsor**

Summary CFs and IRRs	Year 0	Year 1	Year 2	Year 3 (Project sold)
Overall Project CFs	(\$20,000,000)	\$1,270,000	\$1,308,100	\$22,432,739
Project IRR	8.2%			
Overall Equity and CFs – Before Fees	(\$6,000,000)	\$675,000	\$713,100	\$7,837,739
Equity IRR	16.9%			
Equity Multiple	1.54x			
Overall Equity and CFs – After Fees	(\$6,060,000)	\$615,000	\$653,100	\$7,672,312
Equity IRR	15.1%			
Equity Multiple	1.48x			

  

Investor and Sponsor Returns	Year 0	Year 1	Year 2	Year 3 (Project sold)
Investor Cash Flows	(\$4,848,000)	\$492,000	\$522,480	\$5,979,095
Investor IRR	14.2%			
Investor Multiple	1.44x			
Sponsor CFs – Before Fees	(\$1,212,000)	\$123,000	\$130,620	\$1,693,217
Sponsor IRR	18.6%			
Sponsor Multiple	1.61x			
Sponsor CFs – After Fees	(\$1,212,000)	\$183,000	\$190,620	\$1,858,644
Sponsor IRR Including Fees	25.3%			
Sponsor Multiple Including Fees	1.84x			

**The Cash Flow Waterfall.** Figure 4 shows the waterfall structure; the term “waterfall” describes how the cash flows are captured by the stipulations of the promote structure as funds “fall down” the spreadsheet. It should be read from the top with the cash flows followed on a year-by-year basis.

The first task is to deduct the fees from the equity cash flows to obtain the net equity cash flows available for distribution to the investors and the sponsor. Then, follow the sequence outlined in the promote structure. The waterfall includes two IRR checks to make sure the investor distributions are calculated correctly and an overall summation check to make sure that all available cash flows have been distributed and accounted for.

This example shows that the rewards from a simple promote structure are significant for the sponsor. These rewards need to be tempered with the knowledge that the fund structure brings a host of relationship, reporting and fiduciary duties that will need to be executed in a professional and transparent manner. In the end, each sponsor must decide whether the rewards compensate for the increased complexity and potential liability.

Figure 4  
The Real Estate Private Equity Waterfall

Year	Year 0	Year 1	Year 2	Year 3 (Project sold)
<b>Summary of Sponsor Fees</b>				
<b>Equity CFs</b>	(\$6,000,000)	\$675,000	\$713,100	\$7,837,739
Acquisition Fee	\$60,000			
Management Fee		\$60,000	\$60,000	\$60,000
Disposition Fee				\$105,427
<b>Net Equity CFs</b>	(\$6,060,000)	\$615,000	\$653,100	\$7,672,312
<b>1. Preferred Return Hurdle for Investor</b>				
Beginning Capital Balance	\$4,848,000	\$4,848,000	\$4,743,840	\$4,600,867
Req Return		\$387,840	\$379,507	\$368,069
<u>Distributions</u>		<u>\$492,000</u>	<u>\$522,480</u>	<u>\$4,968,937</u>
Ending Capital Balance		\$4,743,840	\$4,600,867	\$0
<b>IRR Check</b>	(\$4,848,000) 8.00%	\$492,000	\$522,480	\$4,968,937
Distributions to Investor		\$492,000	\$522,480	\$4,968,937
<u>Therefore, to Sponsor</u>		<u>\$123,000</u>	<u>\$130,620</u>	<u>\$1,242,234</u>
Total Distributions		\$615,000	\$653,100	\$6,211,171
Remaining CFs		\$0	\$0	\$1,461,141
<b>2. Second Return Hurdle for Investor</b>				
Beginning Balance	\$4,848,000	\$4,848,000	\$5,034,720	\$5,217,101
Req Return		\$678,720	\$704,861	\$730,394
Prior Tier Distributions		\$492,000	\$522,480	\$4,968,937
<u>Distributions</u>		<u>\$0</u>	<u>\$0</u>	<u>\$978,558</u>
Ending Balance		\$5,034,720	\$5,217,101	\$0
<b>IRR Check</b>	(\$4,848,000) 14.00%	\$492,000	\$522,480	\$5,947,495
<b>3. Sponsor Catch-Up</b>				
Distributions to Investor		\$0	\$0	\$978,558
<u>Therefore, to Sponsor</u>		<u>\$0</u>	<u>\$0</u>	<u>\$419,382</u>
Total Distributions		\$0	\$0	\$1,397,940
Remaining CFs		\$0	\$0	\$63,201
<b>4. Remaining Distributions: Net Proceeds and Net Cash Flow</b>				
Distributions to Investor		\$0	\$0	\$31,600
<u>Therefore, to Sponsor</u>		<u>\$0</u>	<u>\$0</u>	<u>\$31,600</u>
Total Distributions		\$0	\$0	\$63,201
<b>Distribution Summary</b>				
Total to Investor	(\$4,848,000)	\$492,000	\$522,480	\$5,979,095
<u>Total to Sponsor</u>	<u>(\$1,212,000)</u>	<u>\$123,000</u>	<u>\$130,620</u>	<u>\$1,693,217</u>
Total Distributions	(\$6,060,000)	\$615,000	\$653,100	\$7,672,312
<i>Check</i>	<i>Correct</i>	<i>Correct</i>	<i>Correct</i>	<i>Correct</i>

# Case Study: Neyer Properties Value-Add Fund III, L.P.

## Background

Dan Neyer, CEO of Neyer Properties, gathered his staff together during the 2008 recession as worries about the economy grew. He described three options to those in the room: the company could sell what it could and retreat from the market; it could hunker down and try to survive, knowing that options were limited as it waited for tenants that might default or activity to slow; or, it could embrace the challenge and look for opportunities to grow as other companies pulled back. Neyer Properties chose the latter path, and since 2008 the company assets have increased from \$100 million under ownership to now over \$500 million with a portfolio of 85 properties across four states. One of the critical mechanisms that helped achieve this growth was accessing external equity capital by raising four funds totaling \$60 million between 2009 and 2014.

Neyer Properties, based in Ohio, started in 1995 and grew out of a long-established family company active in commercial development and construction. Dan's proven ability to assess risk and act decisively befitted his firm's reputation as he focused on opportunistic deals in the local market. Sourcing equity using both internal resources and those of joint venture partners allowed Neyer Properties to grow from its inception. However, the financial crisis and subsequent credit freeze changed the landscape for real estate investment. Many of the joint venture partners Dan had worked with in the past were reluctant to commit new funds to real estate. Banks and other debt providers were also unwilling to make loans in an environment where real estate prices began to fall sharply. Neyer Properties was fortunate to not be overleveraged going into the crisis, and even though capital was scarce, Dan started to consider ways to capitalize on the deeply discounted properties coming to the market.

## Private Equity as an Alternative Source of Capital

For Neyer Properties, setting up a private equity real estate fund provided a source of capital that could be quickly accessed, offered a high degree of discretionary management control (within the operating parameters of the fund) and allowed for certainty of closing when bidding on distressed properties. It was one of the few options available at that time to source capital.

Looking at the investors in the third fund as an example, all were accredited, high-net-worth investors. The minimum fund commitment was \$200,000, and the total funds raised amounted to \$25 million. In some cases, financial advisors acted as aggregators; that is, they combined investments from

several clients to reach the fund minimum, which allowed smaller investors to participate. The company prepared marketing materials and promotional information that highlighted its track record with examples of previous investment deals. It targeted investors through professional networks in the local region and found that many potential investors were either aware of the reputation of the firm or felt more comfortable dealing with a local person. It also worked with local investment advisory firms and leveraged connections with its professional service firms to reach potential investors. Going directly to investors avoided placement costs associated with raising funds. However, in some instances, a fee of 0.5 percent was involved when an underwriter brought clients into the deal. Other fees averaged around 0.5 percent for the accounting and legal costs associated with setting up the fund.

The legal structure for the fund is an LLC domiciled in Delaware. It is structured with a general partner and limited partners. Neyer Properties receives fees for services performed for the fund, and these are benchmarked against competitive rates that would be provided by external firms performing these services (see approximate fee structure below).

#### **Fee Structure:**

- Fundraising fee: None, other than organizational costs
- Acquisition or disposition fee: 1 percent
- Asset management fee: 1–1.5 percent annually
- Finance and guarantee fee: 1 percent finance fee
- Fee on personally guaranteed loans: 1 percent
- Property management fee: 4 percent
- Leasing fee: 1 percent
- Construction fee: 2 percent
- Development fee: 4 percent

## Investment Strategy and Fund Risk

The investment strategy of the fund also focused on the local area, with a stated value-add strategy focused within 150 miles of Cincinnati (see below).

**Investment Thesis:** To acquire value-add medical, office, industrial and retail buildings within 150 miles of Cincinnati, based on the following criteria:

- Asset size between \$2 million to \$20 million.
- Properties that will provide long-term appreciation.
- Within proximity of a major highway.
- Significant discount-to-replacement value.
- Within areas that will continue to have positive growth to allow for future occupancy and values to increase.

Given the opportunistic nature of the fund, the overall IRR was projected to be in the range of 18–20 percent. Indeed, one of the challenges faced by Neyer Properties was that the success of its early funds led many investors to expect high rates of return in subsequent fund offerings, which were no longer achievable in improved market conditions.

The returns to investors were structured as an 8–10 percent (different funds had differing rates) preferred rate of return on equity until all the initial capital had been returned. Remaining cash was split 75 percent to investors and 25 percent to Neyer Properties. To align the interests of the sponsor with investors, Neyer Properties agreed to co-invest a minimum of 10 percent of each fund. Co-investment is an essential mechanism to ensure that the fund sponsor is committed to the interests of investors. The fund also used leverage to increase asset value, with a target loan-to-value ratio of 65 percent.

In promoting the fund to investors, one of the key areas of risk assessed by investors was the prominent role played by Dan in executing the strategy of the fund. As an entrepreneurial company, Dan's leadership of Neyer Properties was an important asset that was attractive to investors. However, this was also seen as a risk for investors if anything adverse were to happen that would prevent Dan from making decisions. Investors needed to be comfortable with the key executives in the company beyond the CEO, and Neyer Properties pointed to the extensive experience of its other executives to demonstrate the "bench strength" within the firm.

Reporting to fund shareholders occurs quarterly, and an end-of-year tax report is also issued.

## Lessons Learned

It is important to reiterate that a large part of the success in raising capital through a private equity real estate fund is the track record and reputation of the sponsor. The terms of the offering need to be fair to the investor, with a focus on achieving performance through successful real estate deals and not as a vehicle to generate fee income. It is also important that interests are aligned with investors through co-investment and a performance component once capital has been returned to investors. For small funds, it is also advisable to keep the structure simple and avoid overcomplicating the return waterfall.

Since 2015, Neyer Properties has not issued any new funds. The company currently has sufficient capital and does not see the current environment as conducive to its value-add investment approach. However, it may be considered in the future as a vehicle to raise capital against its stabilized property portfolio, although such a fund will have a lower return target than in the past, which also reflects the lower risk profile of the investment.

## Conclusion

Real estate private equity funds allow sponsors to share the returns that are created by “hands-on” management of real estate investments. Sponsors with a clear strategy and a well-defined investment product can partially provide investors with superior risk-adjusted returns in their investment portfolios. One of the great ironies of real estate private equity is that this generally high-risk/high-reward investment product finds a natural home in the portfolios of low-risk/moderate-return investors such as pension funds, life insurance companies, sovereign wealth funds and high-net-worth families.

For investors in real estate private equity, the unique characteristics of their returns can make relatively small allocations to real estate (relative to stocks, bonds and Treasury bond allocations) a large contributor to overall portfolio risk management while producing significant current returns to the portfolio, unlike allocations to stocks and Treasury bonds. These benefits, however, only come from well-executed strategies that fall into the five fund strategies mentioned previously.

Real estate private equity funds provide one of the best governance structures because investors, if they choose carefully, are more likely to trust the sponsor, who is incentivized to manage the fund properly. Sponsors must commit to hard work and dedication through the life of the fund. If they do not, they will not earn the promoted interest. Sponsors’ compensation is tied to the return performance of the fund, with significant deferred compensation earned for their efforts to “deliver the goods” to investors.

# Appendix: Example Summary of Principal Terms from a First Fund

## Appendix: Example Summary of Principal Terms from a First Fund

The Fund	Proposed Real Estate Fund, LP.
Offering Size	\$80,000,000 with a minimum commitment of \$3,000,000.
GP Commitment	\$4,000,000.
General Partner	Proposed Real Estate Fund GP, LLC.
Target Return	The Fund will target a 13–15 percent net IRR for the Limited Partners.
Investment Restrictions	The Fund may not invest more than 25 percent of the Fund in any single asset without approval.
Investment Period	Third Anniversary of the Final Closing.
Term	Tenth Anniversary of the Final Closing, unless extended by the General Partner in its reasonable discretion as necessary to liquidate any then remaining Investments.
Management Fee	2 percent per annum of the Limited Partners' commitment during the commitment period; thereafter, 2 percent per annum of the Limited Partners' unreturned investment contributions.
Distributions	Each investment of the Fund will be distributed as follows: First, 100 percent to the Limited Partners until the Partners receive an 8 percent per annum preferred return; Second, 100 percent to the Limited Partners until the Limited Partners receive their capital contributions; Third, 40 percent to the Partners, 60 percent to the General Partner until the General Partner has received 20 percent of distributed profits; Fourth, 80 percent to the Limited Partners, 20 percent to the General Partner
Organizational Expenses	All organizational and offering expenses of the Fund incurred up to \$500,000 shall be borne by the Fund.
Auditor	Top 20 Accounting Firm.
Fund Legal Counsel	Respected Law Firm.
Fund Administration	Respected Third Party Fund Administrator.

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