16 Trends in real estate compensation

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This chapter discusses:

- The main investment strategies and vehicles in real estate private equity and compares how compensation differs for each.
- The range of standard incentive fees and increasingly non-standard incentive fees in the asset class, describing how they tend to be calculated.
- How management fees are applied in real estate private equity and how they feature in different vehicles and at various stage of the investment cycle.
- Ancillary fees earned by real estate managers to supplement their income, ranging from development fees to charges applied to asset sales.

Introduction

Private equity deal structures in general, and manager compensation in particular, have been impacted in the aftermath of the financial crisis that began in 2007. Real estate equity investment vehicles have not been immune from this change. This chapter reviews current manager or general partner compensation trends for various investment strategies and vehicles in the real estate equity arena.

In terms of structure and governance, real estate investment vehicles look very different from the structures and governance that existed pre-Lehman. In terms of manager compensation, for the most part, the impact has not been seen in dramatically different or new compensation structures, but rather has manifested itself in the same structures but with terms generally more in favour of the limited partner investors.

This chapter will focus on some of the more important trends in compensation for real estate investment vehicles.

Strategies and structures

Real estate investment strategies

There are three or four major investment approaches or strategies in real estate private equity. In this chapter we will use the traditional tripartite approach and combine core-plus with core as there is not a dramatic distinction between core and core-plus compensation structures. However, there is a substantial differentiation in compensation structure among the other three real estate investment styles. Brief descriptions of each style and some compensation themes are described below.

Core

The core investment strategy is the least risky of the strategies. It involves acquisition and management of existing buildings that a) are fully or near-fully leased; b) do not require substantial short-term capital improvement dollars; and c) are conservatively leveraged. Befitting this strategy's relative lack of risk, core compensation structures are more orientated towards cash flow than capital appreciation. And core investment structures generally have the least focus on incentive-based compensation. In today's market, core investments are typically targeting leveraged returns, before manager fees, in the range of 8 percent to 12 percent. The recent Management Fees & Terms 2011 study by the Pension Real Estate Association (PREA) indicated an average target before fee return of 11.2 percent.

Value-added

The value-added approach is the next highest on the risk spectrum. The strategy involves a) acquiring existing buildings which, in most cases, are generating some operating cash flow; and b) spending capital to improve the asset in some manner, and thereby either increasing lease revenues or reducing operating costs. Often value-added properties have higher-than-market-rate vacancy, lower-than-market rents and/or require substantial capital improvement dollars to spruce up interiors and fix antiquated operating systems. Examples of value-added investments are a) improving the occupancy and tenant mix at a retail mall; b) systematically renovating apartment units; or c) improving the common areas of an office building and introducing 'green' building systems. Value-added investments combine the routine management elements of a core investment with the capital appreciation elements of an opportunistic investment (discussed below) and thus their compensation structures, like their risk profile, slot in between the other two strategies. Currently value-added investments are typically targeting leveraged returns, before manager fee, in the range of 12 percent to 18 percent, with an average as reported by the PREA study of 17.2 percent.

Opportunistic

The opportunistic strategy has the highest risk. Either there is no current income or the current income is at substantial risk due to high leverage or market conditions. These investments include land without perfected development rights, ground-up development, substantial renovation and repositioning, highly leveraged investments, investment in emerging markets and other high-risk approaches. Opportunistic investments are generally focused on capital appreciation and thus have the highest emphasis on incentive compensation. Opportunistic investment vehicles are typically targeting leveraged returns, before manager fee, in excess of 18 percent, with the PREA study average being 20.6 percent.

Real estate investment vehicles

Real estate private equity has a wide variety of investment structures, and compensation structures can differ substantially depending on the investment vehicle structure. The more common structures are briefly summarised below. It is also important to note that there is a tendency for certain investment strategies to be found in certain investment structures. However there are many exceptions to this generalisation to be found in the marketplace.

Open-ended funds

Open-ended funds are typically large, multi-investor funds. The size of an open-ended fund varies, but is often in the billions of dollars and typically includes a manager co-investment commitment. Open-ended funds do not have fixed investment periods or termination dates. They typically focus on core investments, although many also dabble in value-added properties. Some open-ended core funds even have an allocation for ground-up development.

Closed-end funds

Closed-ended funds are also multi-investor funds but cover a much larger range of size compared with their open-ended brethren. Fund size can vary from $100 million or less to more than $10 billion. Closed-end funds have fixed a) investor subscription periods; b) investment periods; and c) termination dates. The investment manager typically co-invests alongside other investors. All real estate investment strategies are represented in closed-end funds. However, the majority of opportunistic strategies utilises this structure and the value-added strategy is also well represented.

Joint ventures

Joint ventures are typically arrangements between a manager acting as a general partner (or managing member) and a single limited partner investor, although there could be more than one limited partner. The manager will also be a co-investor in most joint ventures. Joint ventures can be formed to undertake any investment style, and all styles are well represented.

Separate accounts

Separate accounts are arrangements between a manager and a single investor. They are distinguished from joint ventures primarily by the lack of co-investment by the manager although occasionally one can find a separate account with manager co-investment. Separate accounts can be formed for any investment strategy, but typically are used for core and to a lesser extent, value-added investments.

Fees

Private equity real estate managers generally are compensated both on value created and for services provided. The latter includes such items as asset management, acquisition and disposition. The primary compensation for value creation is the incentive fee which is discussed below. The management fee is discussed later in the chapter.

Incentive fees

Since there is not a significant amount of appreciation in core and core-plus strategies, incentive fees are modest for these strategies. For the value-added and opportunistic strategies, incentive fees are the primary profit-distribution mechanism as management fees are designed primarily to cover the managers' costs. Incentive fees are thus the primary method for investors to motivate and incentivise managers. They are also the primary method for managers to earn a profit for their work and investment acumen. The vast majority of incentive fee structures are based on the total return to the investor(s), typically measured using internal rate of return (IRR). However, the recent market upheaval has created an environment in which other ideas are also being tested.

Traditional incentive fee

The most common structure for an incentive fee in real estate private equity is a specified percentage of profits over and above return of capital and a preferred return to the investor. For example, a manager might earn 20 percent of the profits after the investor has received its capital back plus a 9 percent annual return on that capital – a 9 percent preferred return or hurdle rate and a 20 percent profit or promote percentage. This is sometimes also phrased as: 20 percent of the profits after the investor has earned a 9 percent IRR. Although there are subtle mathematical differences between the two formulations, that distinction is not material to this discussion. The manager additionally receives a return on its co-investment, just as any other investor.

As simple as the above formulation appears, there are at least six elements that must be understood to actually implement the calculations. Each of these is discussed below, including a brief commentary on the trajectory of change, if any, for each element. There is also a host of purely mechanical, mathematical issues to consider, but these are beyond the scope of this chapter.

Basis for calculation

The first element to consider is how performance is measured in terms of groups of assets and performance time period. Is the manager being compensated on the performance of an individual asset or a group of assets? Is the manager compensated at the asset disposition or at a pre-specified date, say every five years? There is also a variety of hybrid answers to these questions.

The following bullet points summarise the major approaches.

- **Individual asset performance.** This is a relatively uncommon structure between an institutional investor and an institutional manager, although it is more common between capital allocators and operating partners. In the former case there would almost always be some form of 'crossing' of the individual asset performance with other assets. However, as between an allocator and a real estate operator, there may or may not be some form of crossing of incentive fees among assets. We do not foresee a return to incentive fees based on single-asset performance in an institutional context with the exception of, of course, large single-asset investments. And even in that case, investors may ask for some form of crossing of performance with other vehicles that the manager might be managing for that investor. Some methods for crossing the performance of an individual asset with the entire portfolio or tranche are discussed later in this section.
- **Rolling realised performance.** This is a relatively uncommon approach, but it does have a certain degree of intuitive appeal. In a rolling realised system, the manager will be paid an incentive fee based on the accumulated performance of all assets that have been sold or realized over time. For example, consider a portfolio with five assets all acquired at time zero, with one asset sold at the end of each year for five years. In a rolling realised system, at the end of the first year the manager would receive an interim incentive fee payment based on the cash flows associated with asset number one (sold at the end of the first year). At the end of the second year there would be an interim payment (if earned, of course, and taking into account any incentive fee already paid) based on the cumulative cash flows from asset number one and asset number two, and so on. We believe that this is an approach that will increase in popularity for institutional investment structures that allow for interim incentive fee payments.
- **Exceeding the hurdle rate.** This approach is very common in closed-end funds. Incentive compensation is based on the performance of the entire portfolio, but

payments begin after investors have had their capital returned and their preferred return distributed. Essentially, this treats unrealised assets as being 'worthless' until they are realised. In this structure, it is unlikely that investors need to be protected by crossing the payments calculated based on actual realised asset cash flows with the performance of the entire portfolio unless the investor is responsible for contributing additional capital after the incentive fee payments are made. This is likely to remain a popular basis for incentive fee calculations for all investment structures with the exception of open-ended funds.

- **Periodic payments.** This approach would be most commonly found in separate accounts and joint ventures which have a relatively long intended life – sometimes measured in decades. Incentive fee payments would be calculated on a portfolio basis at specific times identified in the investment structure documentation. Calculations in this case include both realised and unrealised assets, with the latter being subject to a 'deemed sale', typically at appraised value, less a deemed 'cost-of-sale' adjustment. This approach is likely to remain popular in situations where managers desire an incentive fee, but investors in long-term core strategies do not want to be compelled to liquidate assets.

Hurdle rate

The hurdle rate – the rate of return that an investor must achieve before a manager begins to earn a share of the profits as an incentive fee – is almost always specified on a leveraged basis.

In an institutional setting, initial hurdle rates generally range from a low of about 6 percent to a high of about 12 percent in a single hurdle system. Most investment vehicles specify the hurdle rate as a nominal rate. However, some investors prefer to specify the hurdle as a 'real' rate, that is, a return achieved after adjusting for inflation. The mathematics to calculate whether the real hurdle has been achieved is as follows:

$$\text{Real hurdle rate} = \frac{(\text{Nominal hurdle rate} + 1)}{(\text{Actual inflation rate} + 1)} - 1$$

which is then combined with actual inflation to determine the nominal hurdle rate. The mathematics of this is as follows:

$$((1 + \text{real hurdle rate}) * (1 + \text{actual inflation rate})) - 1 = \text{Nominal hurdle rate}$$

It is not uncommon for non-core investment structures to include more than one hurdle rate and more than one incentive fee percentage. For example: 20 percent over a 10 percent hurdle and 30 percent over a 15 percent hurdle. While in past years it was not unusual to see structures with multiple tiers, particularly in joint ventures, since the economic downturn there has been a movement towards structures with fewer tiers.

Profit percentage

Traditionally, the incentive fee percentage for institutional money managers has been 20 percent for value-added and opportunistic strategies, at least above the first hurdle. Higher profit participations can be seen over second and third hurdles. Lower profit participation is more common for core investments. Lower profit participation may also be found in non-core separate accounts and joint ventures where the investor is the exclusive provider of capital and can therefore negotiate a lower incentive fee structure. We anticipate that there will be more, rather than less, variability in incentive fee percentages going forward.

Catch-ups

Catch-up provisions allow for the manager to receive the profit percentage of all profits, not just profits available after the investor has reached the hurdle. However, the distribution is made only after the investor has reached the hurdle. Therefore, profits after the hurdle has been reached are distributed disproportionately to the manager until the manager has caught up to the profit percentage of all distributions made thus far. Catch-ups are mostly seen in riskier investment strategies.

For example, a catch-up provision might read something like the following: *After the investors have received a full return of capital plus a 9 percent preferred return, the manager will receive 50 percent of the cash flow until the manager has received 20 percent of the total distributions of the venture. Thereafter, the manager will receive 20 percent of the cash flow and the investors will receive 80 percent of the cash flow.* Pre-financial crisis, catch-up rates were often high and could reach 100 percent. Recently, however, catch-up rates are trending lower with 50 percent not being uncommon.

Catch-ups have many variations which can have a high degree of complexity. However, it should be noted that, in the aftermath of the financial crisis, catch-ups in real estate private equity have become much less common as the pendulum has generally swung back in favour of the investor *vis à vis* the manager. Nonetheless, some rockstar managers have been able to retain a catch-up provision of some sort in their deals.

Qualifiers and benchmarks

Historically, incentive fees have been earned based on the performance of an asset, portfolio or tranche as compared to a particular hurdle structure specified directly in the investment vehicle documentation. This structure does not measure performance compared to the market. In other words, the manager may have met the hurdle during the measurement period but still underperformed the market.

The comparison of manager performance against market performance is a 'qualifier' test which the portfolio performance must meet in order for the manager to qualify to earn some or all of its incentive fee. In the past, that benchmark was often some version of the NCREIF Property Index, which is quarterly compilation of individual asset and projected returns from a large number of investment managers. Another, newer, index being used today captures the performance the major individual open-ended funds, which typically have core strategies, and is called the Open-ended Diversified Core Equity Fund Index (ODCE, pronounced 'odyssey'). ODCE is becoming increasingly important as a benchmark which can impact compensation terms for managers in all strategies and all investment structures. Investment Property Databank indices are also used as qualifiers in some cases.

While the differences between the NCREIF and ODCE and IPD indices are well beyond the scope of this chapter, we note that, for a variety of technical reasons, some investors with non-core strategies are choosing to utilise ODCE as a benchmark rather than a version of the NCREIF Property Index.

Requiring an investment to meet or exceed a benchmark in order for a manager to qualify for some or all of its incentive fee is becoming more popular and we believe that this trend will continue. We do not see, however, a movement towards replacing fixed (or 'real') hurdles with hurdles composed of actual benchmark results plus a spread. That is, we do not expect an incentive fee structure that would read: *The manager will earn 20 percent of the profits after the investors have achieved a full return of capital plus a return of ODCE plus 300 basis points*. We see the use of benchmarks remaining as a binary qualifying test for a manager, and if they qualify for an incentive fee, the fee will be calculated in the traditional manner. Finally, achieving a minimum equity multiple is also increasingly being used in some form as a qualifier for incentive fee payments.

Interim payments, clawbacks and holdbacks

As alluded to in the earlier in this chapter, under *Basis for calculation,* there are numerous incentive fee structures that allow for a portion of the incentive fee to be paid before the realisation of all of the assets in a portfolio or tranche. Whenever there are interim payments allowed, the limited partner investors are at some degree of risk (whether it is a greater or lesser degree depends on the details of the investment vehicle structure) that they will pay out money to a manager during the course of the investment that in the end the manager does not deserve based on the ultimate performance of the portfolio or tranche.

There are many mechanisms used to a) minimise the risk of making such payments; and b) secure the timely return of any overpayments. Two of the more common approaches to address the risk of overpayment are holdbacks and clawbacks. The concept of a holdback is for the investors to pay the manager only a portion of the amount of the incentive fee calculated at any interim payment event. For example, if a manager were to earn an incentive fee of $1 million based on the performance of a portfolio through a certain point in time, the investors would only pay, say, 50 percent or $500,000, while holding back the second $500,000 until it was clear that the subsequent performance of the portfolio was sufficient to ensure that the manager would really deserve all of the money calculated at the interim calculation date.

The concept of a clawback is that the manager agrees to repay the investors should it turn out that the manager received interim incentive fee payments that, in the aggregate, exceeded the incentive fee that should be paid based on the cumulative performance of the entire portfolio or tranche.

Holdbacks and/or clawbacks have typically been a part of most investment vehicle structures that had interim payment structures prior to a full return of capital and preferred return to the investors. However, over the last few years, both holdback and clawback provisions have become more stringent and we anticipate that to remain the case in the short term.

Non-traditional incentive fees

In addition to the traditional incentive fee structure discussed above, there are several non-traditional incentive structures that can be used, particularly for core strategies.

Cash-yield incentive. This approach provides the manager the opportunity to earn an incentive fee based on cash flow from operations (as distinguished from capital events such as financing or sale). As institutions are increasingly shifting to cash flow as a real estate investment objective, there are those who believe that incentivising a manager to maximise cash flow provides good alignment of interest between the manager and the investor. In addition, for core strategies, after acquisition, cash flow is really the primary performance variable within the manager's control. The other determinant of asset value is the capitalisation rate which is determined by market forces generally beyond the manager's control.

Other 'bonus' concepts. From time to time investors in separate accounts (and perhaps some joint ventures) can incentivise real estate managers by providing a bonus calculation based on whatever particular variable might be important to the investor at a given time. Examples might include a) acquisition volume; b) disposition volume; c) reduced capital improvements; or d) implementation of 'green' initiatives.

No-incentive fee

While one would be hard-pressed to find a value-added or opportunistic investment vehicle that did not have some form of incentive fee, it is not uncommon to find core-style investments without an incentive fee. Generally these would be found in open-ended funds or separate accounts. Although most core investment vehicles do have some form of incentive fee, the recent PREA 2011 Management Fees & Terms survey found that almost half of all open-ended core funds and a smattering of separate accounts did not charge an incentive fee.

Management fees

As alluded to in the previous section, management fees are generally portrayed as being something of a cost-recovery item for managers. This portrayal is almost universally the case for closed-end funds with value-added and opportunistic strategies. Almost by definition it cannot be the case for open-ended core funds, joint ventures or separate accounts that have no incentive fee structure.

One of the key distinctions with respect to management fees is how they are treated during the investment period in contradistinction with how they are treated after the conclusion of the investment period. This phasing itself points to an important distinction, because the concept of investment period is really something that is far more relevant to closed-end funds than it is to open-ended funds and separate accounts. Joint ventures may or may not include a specified investment period. A significant majority of closed-end funds charge management fees differently during these two periods, while the majority of open-ended funds, joint ventures (even those that do have an investment period) and separate accounts do not. Indeed, in many cases the distinction between 'during investment period' and 'after investment period' for management fees is not even meaningful for open-ended funds, joint ventures and separate accounts.

Closed-end funds

As noted above, a majority of closed-end funds charge management fees differently during the investment period (the period during which the fund can make new investments) compared with the period after the investment period. During the investment period, industry practice is generally to charge a percentage of capital committed as the management fee. Table 16.1 shows the 'asking price' distribution of this percentage for funds in the market during 2010 and 2011.

Table 16.1: **Distribution of management fees charged during the investment period**

Range	Distribution
< 1.00%	6%
1.00 - 1.24	13%
1.25 - 1.49	6%
1.50 - 1.74	45%
1.75 - 1.99	11%
2.00 - 2.24	16%
>= 2.25	3%

Source: *2012 Preqin Global Real Estate Report*

Although the data is self-reported, and likely does not fully reflect discounts given to large investors in side letters or through other tiering mechanisms, anecdotal evidence suggests that the majority of closed-end funds end up in the 1.25 percent to 1.50 percent range for management fees during the investment period. Larger investors are likely to be in the next lower cohort: 1 percent to 1.24 percent. Fees for opportunistic funds are likely to be higher than for value-added funds due to the perceived greater difficulty in sourcing and underwriting opportunistic investments.

After the investment period, management fees are typically, although not universally, lower, reflecting the belief that it is more costly to source and underwrite investments than it is to manage them. Mechanisms for reducing the management fee include a) changing the calculation from a percentage of investors' committed capital to a percentage of invested capital; b) reducing the rate charged on committed capital; c) both lowering the rate and changing the basis to invested capital; and d) using some other basis for calculation such as gross asset value, net asset value or net operating income.

For the most part, however, closed-end funds utilise invested equity as the basis for calculation after the end of the investment period. According to the PREA study referenced above, both the mean and the median post-investment period management fee percentage in its 2011 survey was approximately 1.2 percent.

Although there was not a considerable spread, not surprisingly the lowest management fee after the investment period was for core strategies, the highest was for opportunistic strategies, with value-added strategies being in the middle.

Open-ended funds

Open-ended funds do not generally exhibit the distinction between the investment period and post-investment period found in the closed-ended funds. In addition, management fees are generally based on asset value, with most calculated as a percentage of net asset value (after leverage) and a minority calculated based on a percentage of gross asset value (before leverage). The applicable percentage would naturally be lower for those funds using gross asset value. The 2011 PREA study showed an average management fee of 89 basis points on net asset value.

We expect to see that number slightly decline in the short term due to a) increased competition in the open-ended core fund space; and b) economies of scale that can be achieved as the successful open-ended funds increase in size. The seeming anomaly between the industry experiencing both increased competition and increased scale can be explained by the considerable upsurge in interest in core strategies that is currently being experienced in the institutional investment sector.

Joint ventures and separate accounts

Generally these structures will look more like open-ended funds than closed-end funds. However, by committing a considerable amount of capital to a single manager, investors often can achieve lower fees and more favourable structures. Managers, for their part, are willing to accept lower fees since they can secure a relatively large commitment of capital from a single source and generally can expect reasonable longevity and loyalty as long as they are performing up to expectations.

Other sources of compensation

Depending on the specific manager and the specific investment strategy, there are various ancillary fees that may also be earned by a manager to augment compensation. Some of the more important ancillary fees are briefly described below.

Acquisition fee. This fee compensates the manager for the costs associated with the acquisition of a project. This fee is typically a fixed percentage or a sliding scale of percentages, applied to gross asset value or equity invested. In some cases, managers forego this fee and instead directly charge the joint venture for acquisition costs.

Disposition fee. This is a fee for disposing of an investment. This fee is more likely to be found if no external broker is utilised, although occasionally a small fee may be charged even if a broker is used. This fee is generally a percentage applied to the sales price. In cases where an external broker is used, the cost of the external broker may be deducted from the fee due to the operating partner.

Financing/refinancing fee. A manager may charge a fee for sourcing and securing financing for a project. This is more likely if no external mortgage broker is utilised, although occasionally a small fee may be charged even if a broker is used. This fee is generally a percentage applied to the amount of the financing secured. In cases where an external broker is used, the cost of the external broker may be deducted from the fee due to the manager.

Development fee. This would apply to development projects and compensates the manager for supervising development activities. This fee is generally a fixed percentage applied to project costs (sometimes stated as the lesser of budgeted or actual costs), although there can be some negotiation over just precisely which costs are allowed for purposes of this calculation. For example, land value and construction financing costs are sometimes excluded.

Construction management fee. This fee, which compensates the manager for construction management service, could apply to both new construction and/or rehabilitation/redevelopment strategies. This fee is generally a fixed percentage applied to project hard costs and sometimes some or all soft costs. This too is sometimes stated as the lesser of budgeted or actual costs.

Property management. In some cases, managers will have affiliated companies that provide property management services. Property management fees are typically either a fixed percentage, or a sliding scale of percentages, applied to revenue, or occasionally net operating income.

Leasing fee. In some cases, managers will have affiliated companies that provide leasing brokerage services for a project. This fee is generally whatever is normal and customary in a given market for leasing brokerage services. In cases where an external broker is used, the cost of the external broker will likely be deducted from the leasing fee due to the manager. In some cases, the manager may receive a small 'override' even though a full market fee is paid to an external broker.

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