Raising Money For Real Estate Deals: Today's Market Terms

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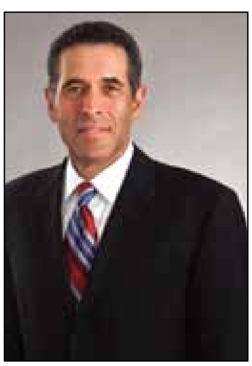

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As debt financing remains challenging to secure, private financing remains an attractive option.

MOST REAL ESTATE INVESTMENTS continue to be financed through a combination of mortgage debt and equity. Over the past few years, the equity requirements imposed by mortgage lenders have risen, increasing the amount of capital real estate entrepreneurs must raise from investors. In today's market, a real estate entrepreneur should expect the equity component of a deal to comprise 25 to 40 percent of the appraised value of the property, and likely higher for development deals and other projects considered more risky. The good news is that private capital remains available for investment. That being said, investors are more risk averse than in days past and, as a result, are scrutinizing deals closely to make sure that the project makes sense, the sponsor is capable of executing, and projected returns appropriately reflect the project's risks.

One of the most common questions posed by sponsors desiring to raise money for a real estate project is, "On what terms should I structure the deal between myself and my investors?" This is an interesting question, and not necessarily one that is easy to answer, in part because the terms for investment are generally not publicly available. Moreover, several variables influence structure including the sponsor's reputation and track record and the risk/return profile of the underlying project. As a result, there is no "one size fits all" answer to this question.

Despite the varying nature of projects and the sponsors who operate them, the economic proposition to investors follows certain trends. This article begins by explaining the key economic terms that appear in today's real estate deals, including the ranges of fees and promotes. Next, this article describes other non-economic terms that commonly appear in today's real estate deals. Lastly, this article explains how the "traditional" structure may be influenced when institutional investors or other sophisticated, big-money investors participate in a real estate project.

The information in this article is premised on a few assumptions and beliefs:

- First, we have assumed that investors are passive investors, fragmented from one another, and are not "friends and family";
- Second, we have assumed that the capital raise is not targeted to one or a few institutional investors, as one or a few institutional investors will be able to demand terms more favorable than smaller, fragmented investors could demand;
- Third, the metrics and data cited in this article are intended to reflect what the authors believe are the most representative figures, but should not be construed as suggesting that deals cannot and do not fall outside the described ranges;
- Fourth, the authors recognize that certain real estate asset classes may be viewed as more risky than others. Most of the data cited in this article is based on the authors' experience in the multi-family, commercial, and industrial property sectors. It is possible that the trends in other sectors may differ. It is also likely that the trends within multifamily, commercial and industrial differ from one another, although the authors have not attempted to discern such differences; and
- Finally, we have assumed that the vehicle for investment is a pass-through entity for tax purposes. For purposes of this article, we generally refer to the agreement between the sponsor and the investors as the "partnership agreement," regardless of the underlying investment vehicle entity type.

KEY ECONOMIC TERMS IN TODAY'S DEALS • This article sets forth the general terms upon which sponsors are raising capital for real estate projects in today's marketplace.

Basic Economic Structure

Most real estate deals share certain economic attributes. In most cases, the first profits are paid to investors until investors are repaid their original investment, plus a preferred return. (In some cases, particularly in the case of income producing properties yielding current cash flow, a sponsor might structure a deal that allows it to participate in its promote once the investors have received a preferred return but before the investors have received the return of their original investment. This is premised on the notion that, in these cases, the investors are not likely to receive their original investment back until the property is sold and the sponsor should not have to wait until the end of the project to start sharing in its promote.) Thereafter, investors and the sponsor share the remaining profits in some manner. In many cases, a sponsor may seek an increasing share of the profits as the return to investors increases. The sponsor's share of the profits is commonly referred to as a "carried interest" or a "promoted interest" or simply a "promote." The designated rates of return that must be achieved in order for the sponsor to start participating in its promote are commonly referred to as "hurdle rates." In addition, as part of the project, the sponsor (or its affiliates) commonly provides various services, such as property management, brokerage, and construction management services. The sponsor is typically paid "market" fees for these services, although the "market" is not well defined and can vary significantly from deal to deal.

Investor Return Metrics

Investors typically evaluate competing investment alternatives on the basis of their return potential. Accordingly, investors expect projections to contain metrics that allow them to quickly size up projected returns. Such metrics are also used by sponsors when crafting deal structure and deciding which projects to pursue, as they assist the sponsor in determining whether the project is expected to provide an attractive return to investors relative to other competing investments. The most common metrics used in real estate deals are cash-on-cash returns, internal rates of return, equity multiples, and sheltered income.

Cash-On-Cash Returns And IRRs

Sponsors most commonly cite the return potential of their project in terms of cash-on-cash return or internal rates of return. Cash-on-cash return is simply the expected annual cash return on the investor's investment, without compounding. In today's marketplace, stabilized projects typically project a cash-on-cash return in the seven to 12 percent range. An internal rate of return (or IRR) is typically defined in real estate deals to be the rate that makes the present value of contributions made by an investor (e.g., its initial investment and any subsequent investments) equal to the present value of distributions received by the investor. An IRR is a valuable metric because it takes into account all cash flows and the time value of money — thereby providing the investor a benchmark by which it can evaluate competing investments. IRRs typically fall within the 15 to 20 percent range.

Equity Multiples

An equity multiple is a metric that describes the amount of cash, in absolute terms, an investor is expected to receive over the life of the investment. It does not take into account the time value of money. It is computed by dividing the total projected cash return over the life of the project, in absolute dollars, by the investor's investment. For example, if an investment projects a multiple of 2.5, an investor who invests a $100 should expect to be paid $250 over the course of the project (including such investor's initial investment). Some financial experts suggest that relying on IRRs alone can lead to making the wrong investment decision, particularly when comparing projects expected to have large expenditures in later years. In these cases, the equity multiple is a good metric to use in conjunction with time value of money metrics because the equity multiple is not influenced by fluctuations in the timing of payments. In today's marketplace, equity multiplies typically fall within the 2.0 to 2.5 range.

Sheltered Income

Another metric that is relevant to investors is "sheltered income." Sheltered income represents that portion of income payable to investors that is not currently taxable to investors because it is offset (or sheltered) by non-cash charges such as depreciation. Most deals that quote this metric project to shelter between 40 and 60 percent of projected income.

Preferred Return

Preferred returns are those returns to which an investor is entitled on its original investment before the sponsor becomes entitled to participate in its promoted interest. In today's market, preferred returns range from eight to 12 percent, and typically do not compound. In those deals that involve compounding returns, compounding does not typically occur more frequently than annually. Ultimately, careful attention must be paid to the calculation of the preferred return, and not just the nominal interest rate itself. For instance, compounding can greatly affect the return to investors such that a lower nominal interest rate, with frequent compounding, may very well yield a higher return to investors than a higher nominal interest rate that doesn't compound. Because of the rate at which the investors' return grows with compounding, sponsors are cautioned against offering compounding rates of return.

Ranges Of Promotes

Promotes are incentive-based returns that allow a sponsor to share in the upside of a project once it has generated an attractive return for investors. There continues to be a fairly large spread in promotes, but most promotes fall within the range of 20 percent, on the lower end, to 50 percent on the higher end, with the most frequently occurring promotes falling in the 30 percent to 40 percent range. Multi-tiered promote structures, which enable sponsors to enjoy higher promote percentages as returns to investors increase, remain common — particularly in scenarios in which investors are projected to enjoy annual returns in excess of 20 percent. As an example, a tiered promote might entail the following distribution hierarchy:

- First, investors receive the return of their initial investment back, plus a preferred annual return of eight percent;
- Second, additional distributions are split 75:25 (investors:sponsor) until investors achieve an annual rate of return of 20 percent on their original investment; and
- Third, additional distributions are split 65:35 (investors:sponsor) after investors achieve an annual rate of return of 20 percent.

Care and attention should be taken in drafting the promote section of the partnership agreement as there are a number of nuances and subtleties that apply with regard to the calculation and implementation of promotes.

Ranges Of Fees

Sponsors regularly provide services and oversight to the underlying project. Sponsors charge fees for these services, all of which fees are typically built into the projections included as part of the offering materials. These fees create predictable streams of income for the sponsor, although they do reduce the amount of cash available for distribution. The chart below sets forth the most commonly agreed upon fees that appear in today's deals, the most representative ranges of those fees, and the frequency at which those fees are charged:

Type of Fee	Range
Acquisition Fee	One percent to three percent of purchase price of real estate (one-time fee)
Finance Fee	.5 percent to 1.5 percent of indebtedness (usually a one time fee)
Loan Guaranty Fee	.5 percent to two percent of guaranteed indebtedness (annual fee)
Property Management Fee	Three percent to five percent of gross collected rents (recurring fee)
Asset Management Fee	One percent to two percent of gross collected rents, where the sponsor does not provide property management services (recurring fee)
Leasing Fee	"Market," based on type of real estate and locale (paid based on leasing activity)
Construction Management Fee	One percent to three percent of total cost of improvements (paid based on construction activity)
Disposition Fee	One percent to three percent of sale price of property, although sometimes this is couched as a brokerage fee, in which case the sponsor may charge a customary brokerage commission, usually five percent, unless a cooperating broker is involved in which case the commission is typically split (one-time fee)

It should be noted that no single deal necessarily includes all fees set forth above if for no other reason than most deals cannot support payment of all such fees and still provide an adequate return to investors. Also, the types of fees described above are merely the most common types of fees that appear in today's deals. Other deal-specific fees may be crafted to account for other services or risks that are rendered or assumed by the sponsor.

Capital Contributions By Sponsors

Now more so than ever, investors are expecting sponsors to invest cash into projects side-by-side with investors or otherwise be at-risk with regard to a project. Accordingly, most sponsors will invest between five percent and 10 percent of the total capital raise. It is not common that a sponsor demonstrate its commitment to a deal solely by promising to contribute its acquisition fee or brokerage commission to a deal. A sponsor may be able to demonstrate similar at-risk commitment to a deal by guaranteeing all or a portion of the mortgage indebtedness or posting collateral security to support debt.

Other Factors That Influence Deal Structure

Deal structure is also influenced by intangible factors. The presence or absence of such factors can significantly influence the key economic elements of a project including the nature and extent of fees chargeable by the sponsor and the level of promotes a sponsor may command. These intangible factors include:

- Reputation and track record of the sponsor;
- Whether the sponsor possesses a particular expertise that is not otherwise generally available in the marketplace; and
- Whether the project, by virtue of its location, stabilization, occupancy, creditworthiness of tenants, or other factors, is perceived to offer a higher potential rate of return or lower risk than other alternative investments.

Putting It All Together

The projects that typically produce the best results, and are structured appropriately, are those that implement a true "partnership"-style approach between the sponsor and the investors. The investors should be rewarded with an attractive return for contributing capital and taking risk. The sponsor commits its time to a project and should be compensated accordingly in the nature of fees. The promote allows the sponsor to share in the upside of a project when the project is well executed. The economics of a deal should be designed with these goals in mind, and should take into account any intangible factors that exist. In the end, metrics should be used to ensure that returns to investors are comparable, if not favorable, to other competing investments.

OTHER TERMS IN TODAY'S DEALS • Today's deals typically share non-economic characteristics as well. Some of the key non-economic terms that define today's deals are discussed below.

Right Of Sponsor To Provide Services And Be Paid

It is commonplace for sponsors or their affiliates to provide services to the project and be paid fees. In fact, the expertise provided by the sponsor may be one reason why the project is believed to have a competitive advantage in the marketplace. The range of services may include, among others, asset management, property management, construction management, real estate brokerage, and mortgage brokerage. In addition, a sponsor or its affiliates may guarantee the loan concerning the project or post collateral in connection with the project, and should be compensated for taking such risk. In any event, the partnership agreement will generally provide that the sponsor or its affiliates be paid on a fair market value basis for its services and will likely identify and specifically approve all fees expected to be paid to the sponsor.

Right To Control Decision-Making

The sponsor or one of its affiliates is typically entitled to make all decisions concerning the affairs of the project, without consulting with or seeking approval from investors. Such decision-making authority not only applies to day-to-day decisions, but big-picture decisions as well. In addition, partnership agreements typically exculpate sponsors from liability for errors in judgment or other acts or omissions unless they constitute misconduct or a high standard of neglect.

Capital Calls

The partnership agreement must address the possibility that the project might require additional funds, either in the nature of additional capital or loans. Investors are typically not required to contribute capital beyond their initial investment. The partnership agreement usually affords the sponsor the prerogative to raise additional funds through the issuance of additional equity, which would dilute the original investor's ownership stake, or through the issuance of promissory notes. In either case, new investors (or new lenders) may be entitled to priority rights to future cash flows. The sponsor typically grants preemptive rights to its original investors so that they are assured of their right to participate, on a pro rata basis, in any future funding needs. In addition, the sponsor usually reserves the right for it or its affiliates to participate in any future funding needs of the project and may specifically set forth the terms upon which the sponsor or its affiliates may make loans to the project.

Handling Of Distributions; Tax Withholding Issues

Like other decisions, the sponsor generally controls whether distributions of cash are made to the investors and the extent of distributions. In pass-through entity structures, the entity may commit to make distributions to cover tax liabilities associated with ownership, although this commitment is customarily subject to the sponsor's right to limit such distribution if necessary to fund operations or reserves. Several states now impose withholding requirements on pass-through entities for investors who reside outside of the state in which the real estate is located. When withholding is required, partnership agreements typically permit the sponsor to offset the amount the entity is required to withhold against amounts otherwise distributable to such investor(s). When withholding is required but no distributions are being made to investors, the partnership agreement will permit the sponsor to offset the withheld amount against future distributions or require that such investor(s) pay such amount to the operating entity to cover the withholding obligation.

Limited Fiduciary Duties

Sponsors are limiting their fiduciary duties to the greatest extent possible. In the context of Delaware limited liability companies, sponsors can contractually eliminate all fiduciary duties other than the implied contractual covenant of good faith and fair dealing. Other state LLC statutes may permit fiduciary duties to be limited or narrowed. For instance, under the Illinois LLC Act, it is not possible to eliminate fiduciary duties but it is possible to identify specific types or categories of activities that do not violate such duties, as long as such types or categories are not manifestly unreasonable. Because Delaware provides the greatest opportunity to limit fiduciary duties, as well as other protections for the sponsor not available in other states, Delaware remains the preferred state of organization for operating entities.

Right To Control Identity Of Investor Group

Sponsors are able to hand-pick their investors, and by virtue of the partnership agreement, are able to prevent transfers of investor interests to third parties. Exceptions are typically permitted if a transfer is being made to family members or other related parties, for estate planning purposes, or upon an investor's death. Sponsors are not required to respect any transfers made in violation of the agreement if those transfers are voided by the terms of the partnership agreement. To the extent transfers are made in violation of the partnership agreement, and are otherwise not voided by the terms of such agreement, the person taking such interest usually loses rights of access to books and records and any voting rights it might otherwise enjoy, and retains only the rights to its allocable share of distributions and tax allocations.

Competing Opportunities

Partnership agreements typically expressly state that all investors and the sponsor are permitted to engage in competitive activities, including other investments in real estate.

Lender Concerns

Commercial mortgage financing is available in the marketplace, but it remains challenging to secure such financing. Some of the most opportunistic buyers are forgoing the delay and uncertainty associated with procuring commercial financing and buying properties with cash or a combination of cash and seller financing. These buyers are adding traditional financing after closing. Once financed, lenders continue to closely monitor cash flows and project performance, and strictly enforce debt covenants. To the extent that partnership agreements mandate the payment of distributions to investors (such as tax distributions), this right is subject to any limitations imposed by the lender.

Tax Allocations

Investment entities, whether organized as partnerships or limited liability companies, are most commonly taxed as partnerships. A partnership does not pay any federal tax as an entity. Instead, each partner (i.e., each investor and the sponsor) is required to report on the partner's federal income tax return the partner's allocable share, usually determined by the partnership agreement, of the income, gains, losses, deductions, and credits of the partnership. In the past, it was commonplace for partnership agreements to include elaborate and lengthy tax allocation provisions. Nowadays, it is common to implement allocation provisions that simply require that allocations be made to the partners in a manner that adjusts their respective capital account to the amount such partner would receive if the partnership sold all of its assets for book value and liquidated.

Taxation Of Partners; Proposed Regulations Affecting Promote Interests

If properly structured, the sponsor's receipt of a promote interest is not subject to immediate taxation. Instead, all of the partners, including the sponsor, pay income tax on their distributive share of the profits of the partnership as it is earned. Currently, all partners, whether the sponsor or investors, are taxed in a similar manner. That is, the character of the income taxed to the partner depends on the nature of the income. Therefore, if the profits generated by the partnership are considered ordinary income, such as operating income, the income will be taxed as ordinary income to all partners (with a highest marginal rate of 35 percent, but increasing to 39.6 percent after 2012). Conversely, if the profits generated by the partnership are considered capital gains, as is the case upon the sale of the property, the income will be taxed as capital gains to all partners (with a highest marginal rate of 15 percent, but increasing to 20 percent after 2012). Various proposals introduced in Congress each year since 2007 have contained carried interest proposals that would treat all or a greater portion of the net income on the sponsor's promote interest as ordinary income for the performance of services. While the stated targets of these proposals have been Wall Street private equity and hedge fund managers, the proposals would apply to the promote interest received by real estate sponsors as well. Under these proposals, all or a greater portion of the sponsor's distributive share of income from the partnership would be taxed as ordinary income. In addition, under these proposals, this ordinary income amount would be subject to self-employment tax (15.3 percent on the first $106,800 (in 2011) of self-employment income and 2.9 percent thereafter). To date, none of these proposals have become law. However, the debate over increasing the tax rates on carried interests has again been raised as part of the Fiscal Year 2012 budget proposal from the White House.

HOW TRADITIONAL STRUCTURE IS INFLUENCED WHEN INSTITUTIONAL INVESTORS BECOME INVOLVED • When private equity or institutional investors invest a substantial amount in a real estate deal, they may require certain protections and controls as a condition to their investments. A sponsor may be required to make the following concessions when dealing with these larger, typically more sophisticated investors.

Returns

Institutional investors may be more demanding in their return on investment expectations. This could manifest in a few ways. First, institutional investors may require higher preferred returns and higher hurdle rates. Second, institutional investors may require that returns be calculated on a compounding basis, and that compounding occur more frequently than annually, so that hurdle rates (and hence the promote interest) are harder to achieve. Lastly, when quick sale of the property has been discussed as a possible liquidation event, an institutional investor may require that the hurdle rate be computed as the greater of a certain return and a multiple of its investment. For instance, an institutional investor may require that the sponsor's promote not kick in until the investor has received the greater of a 15 percent compounding return or two times its original investment. This type of structure ensures the institutional investor of receiving a sufficient return in an exit scenario on an absolute dollar basis.

Clawbacks

Institutional investors may require clawback provisions. Clawback provisions ensure that the sponsor is not over-compensated relative to the intended business arrangement between investors and the sponsor. A clawback makes particular sense in projects that are expected to produce cash distribution events in the earliest years of the project, or otherwise before the project is liquidated, when hurdle rates may be prematurely achieved. In these cases a sponsor may be overly enriched by earlier distributions if performance of the project wanes in later years. A clawback provision typically requires the sponsor to return cash to the investors so that the investors achieve a designated minimum return.

Budgetary Controls

In a typical investment structure, investors may not enjoy any particular controls on the sponsor's ability to spend other than protections afforded by fiduciary duties (to the extent not limited or eliminated). Institutional investors may require approval over, and adherence to, annual budgets. This would naturally limit, among other expenditures, the type and amount of fees that a sponsor or its affiliates could charge for rendering services to the project. In these cases, the failure of the sponsor to adhere to an approved budget can result in liability to the sponsor, removal of the sponsor as the decision-maker and operator of the project, and/or forfeiture of the sponsor's promote.

Participation In Future Capital Needs

An institutional investor may require that it have the right, but not the obligation, to provide any future funding to the project, or that it at least have a pre-emptive right to fund its share of any capital calls. Similarly, an institutional investor may require that it provide any loan required by the project, or that it have a right, but not the obligation, to fund a pro rata portion of any required loan. Moreover, an institutional investor may require its consent as a condition to the sponsor making any additional capital call or incurring indebtedness other than trade debt in the ordinary course.

Participation In Certain Decisions

Institutional investors may require approval over certain decisions concerning the project. Examples of such decisions include:

- Selling the property;

- Incurring indebtedness over and beyond trade debt and other indebtedness expected to be incurred at the onset of the project;
- Raising capital and the terms of any capital raise;
- Redeeming any equity;
- Approving annual operating budgets;
- Making payments, including any payments to the sponsor or its affiliates, other than as set forth in an approved operating budget;
- Removing any important service provider (such as a property manager or leasing agent); and
- Approving events that change the structure or legal status of the operating entity such as a merger, dissolution or bankruptcy.

In some cases, an institutional investor might require complete control over a project.

Right To Remove Sponsor

Institutional investors may require the right to remove the sponsor as a decision-maker and operator of the project under certain conditions. Conditions which typically give rise to removal rights include "bad boy" acts (i.e., fraud, theft, or other acts of dishonesty), violations of fundamental understandings (i.e., sponsor not adhering to budgetary limitations), nonfeasance (i.e., sponsor's failure to act), or failure to meet an objective standard of investment performance over a prescribed period. In any such case, the institutional investor usually reserves the right to designate the successor decision maker and operator. The dynamic whereby a sponsor can be removed as a decision-maker is particularly troublesome for the sponsor if the sponsor or its affiliates guarantees the loan, or has posted collateral for the loan, concerning the project.

Greater Accountability

Institutional investors may require that certain safeguards exist in order to protect fundamental assumptions underlying their investments. For example, in a development project, if the project is premised on a development budget prepared by the sponsor, the institutional investor may hold the sponsor accountable for any cost overruns other than those attributable to changes in scope of the project. Under these types of scenarios, a sponsor can be required to contribute excess cost overruns to the project or otherwise face dilution, forfeiture of its interest, or removal as the operator of the project.

Tighter Controls On Reporting

Institutional investors typically require much more elaborate and frequent reporting than traditional passive investors. Institutional investors may also require that financial reports be independently verified by third parties.

Competitive Limitations

Depending on the nature of the project, institutional investors may impose competitive limitations on the sponsor. For instance, in a unique development project such a condominium or hotel development, the institutional investor may limit the sponsor's ability to engage in competing projects within a certain radius of the project until the project reaches completion (or a certain level of completion).

CONCLUSION • Today's real estate deals follow certain trends. When crafting its investment structure, a sponsor should be mindful of how its deal compares to other competing investment alternatives. In particular, the sponsor should make sure that, after taking into account any fees it proposes to charge and its promote, that the deal yields a competitive return consistent with the risk/return profile of the project. Investor-based metrics can help in this regard. Also, the sponsor should recognize that the way in which it crafts its deals likely defines its perception in the marketplace. Sponsors can become known as "fee driven" versus promoteoriented, so a sponsor should be mindful of how any particular deal may affect how it is perceived. Lastly, inasmuch as the sponsor has the incentive to create deal structures that enrich itself, it should be equally motivated to create structures that yield attractive returns to its investors, thereby creating a true "partnership" relationship. By doing so and executing on its business plan, the sponsor will create a loyal investor base that will make future capital raising easier and likely enable it to consider larger deals.