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Moving Into Private Equity First-time fund managers navigate complexities of legal and practical issues.

by Steven Lichtenfeld

ONE OF THE GROWING trends in the private equity real estate market is the influx of real estate owners and operators sponsoring real estate funds. In 2004 alone, there were 31 new funds representing more than $18 billion in new capital,[1] and the numbers for 2005 and beyond continue to grow. Sponsoring some of these new funds are experienced real estate operators who have joint ventured with other funds in the past but are now seeking to have their own discretionary access to capital.

This access to capital allows sponsors to act nimbly on prospective acquisitions without the distraction or risk of simultaneously raising the equity needed to close the deal. Also characterized as "emerging managers," real estate owners who embark on this journey are often managing institutional third-party capital for the first time. However, it is their expertise in direct real estate investing and their track records which provide institutional investors with a high degree of confidence in their ability to produce superior results.[2] For these owners and operators, navigating the complexities of the various practical and legal issues associated with fund formation can be quite a challenge. Raising capital, positioning the fund to attract investors, and managing potential conflicts are just a few key areas of concern for owners and operators who desire to make the transition to sponsoring a fund.

Rationale

The primary motivation for raising a first-time fund is that fund managers have direct access to discretionary capital and the ability to manage deal flow more efficiently. Owners and operators are often held back by lack of access to capital and are generally forced to raise the equity needed for acquisitions and developments on a deal-by-deal basis. By having direct access to capital, owners and operators can devote their time to pursuing and evaluating investment opportunities rather than chasing the financing necessary to actually execute on those opportunities. In short, operators can bid with confidence and sellers can have certainty that the operator has the financial wherewithal to close.

Another advantage for raising a fund is that an operator can effectively lower the cost of capital. Cost of capital is basically the rate of return a fund would otherwise be able to earn if it chose an alternative investment with the same level of risk.[3] In the real estate private equity realm, for example, if an operator is in a joint venture with a fund that is seeking a gross internal rate return (IRR) of 20 percent, this return must be paid after the operator receives its carried interest. Therefore the operator may have to seek investment prospects that will yield at least a 25 percent IRR so its joint venture fund partner can achieve its 20 percent target IRR.

According to Doug Weill, a managing director at Credit Suisse First Boston, "when working with a fund as a partner the target return is pretty high." Therefore, when an operator is out front as fund manager, this reduces the cost of capital by several hundred basis points, says Mr. Weill. The idea is to eliminate the carried interest to both the opportunity partner and the operator so there is less stress in terms of achieving the target yield. Remarkably, investors are generally not averse to the "double promote."[4]

Disadvantages

One of the difficulties perceived by many operators seeking to make the transition to fund sponsor is the potential loss of access to capital sources via their strategic partners. Owners and operators with considerable experience in the real estate business have often spent years cultivating relationships with their strategic partners. These partners have typically provided the access to the capital needed to close the operator's prior acquisitions and developments.

Many operators are concerned that foregoing these relationships will potentially hurt their ability to access capital should they decide to raise a fund on their own. They are in the unenviable position of having to weigh the advantages of raising their own fund against the risk of ultimately losing support from former capital partners. This clearly impacts the existing real estate fund which does not want to lose a long-standing operating partner. The upside of this is that many existing real estate funds have responded favorably by offering higher incentive fees and asset management fees in order to sustain the relationship. In some cases, the existing real estate funds may not only be willing to re-configure their deals going forward, but also their historical deals in an effort to encourage the operator not to sponsor a fund on its own.

Another big challenge for someone transitioning from operator to manager is the radical change in the compensation model from deal-by-deal bonuses to entity-based incentive compensation. On the operator side, employee compensation is usually paid on a deal-by-deal, cash-bonus structure arrangement. In a fund format, the employees receive entity-based compensation, usually in the form of a share of the carried interest, which is tied to the overall performance of the fund. In essence the equity is participated out to the team and is subject to vesting which is vastly different from a cash-bonus type compensation model. Fund managers face the enormous task of "motivating their team to shift their thinking from deal-by-deal and cash-based compensation to fund equity economics," says Mr. Weill.

Time Line and Size

Many operators underestimate the effort and infrastructure necessary to raise a fund and have unrealistic expectations about how long the process should take. Operators should be prepared to invest a considerable amount of time preparing to market the fund properly and for the due diligence required by placement agents and potential limited partners. A time line of not less than six months and often one year and beyond is reasonable.

The question of how big a first-time fund should be is often raised. First-time funds sponsored by real estate operators can range anywhere from $50 million to $500 million and beyond. The caveat is that many institutional investors seek to invest $10 to $20 million so a $50 million fund would have difficulty attracting this type of investor. To appeal to institutional investors fund managers need to go for the higher end of the spectrum. However, Michelle LeRoy, a partner at Crane Capital, cautions new managers not to take on too much capacity. "If the fund has the pipeline and is confident it can put the money to work, then it should aim for the 200-to-250-million-dollar range," says Ms. LeRoy. Otherwise, raising a smaller fund is preferable if the fund manager is unable to successfully deploy large amounts of capital.

And with the proliferation of new funds in the market creating more competition for investment options that meet return expectations, deploying capital efficiently is difficult.

With more capital flowing into the market, real estate prices have increased, therefore making it difficult to acquire targets that meet investor return expectations.[5] An oversupply of $125 billion in contractually committed capital in the market has driven up prices for assets such that it is much harder to produce solid returns.[6] With the market landscape saturated with capital, operators entering the fund side for the first time can expect to venture further out on the risk spectrum when trying to deploy their capital.[7]

Having a Solid Track Record

Investors are looking for first-time funds that have a national platform and that are niche focused. Investors are starting to "move away from diversified funds and more towards emerging managers and managers who are sector and niche specific," says Ms. LeRoy. To attract investors to a first-time fund, managers should have a national or a specific regional geographic focus and should have a sector-specific track record.

As the lifeblood of the market, institutional investors enjoy a superior bargaining position with myriad funds competing for their investment capital. As fiduciaries, they are compelled to be more vigilant and to proceed with well thought out investment strategies that will provide them with risk-adjusted returns and the cash flow benefits that make private equity real estate funds such a major attraction.[8] As such, today's sophisticated institutional investors demand that fund managers have a solid track record that both is credible and attributable.

The track record should fully disclose all realized and unrealized gains and fund managers must overcome the temptation to omit unsuccessful investments even if they are incongruent with the current strategy.[9] Investors expect full transparency and managers have to be careful not to selectively disclose. Doing so is unethical business practice and may subject the fund manager to potential liability.

Organizing the track record can be the most time-consuming preparation item for market. Oftentimes finding financial statements on the various properties is difficult; in many instances former opportunity fund partners have changed their accounting systems or have reported differently for different capital partners. Jeff Elowe, president of The Laramar Group in Chicago, which recently completed a first-time real estate fund offering, recommends planning ahead to minimize the preparation time required to compile the track record. "We pulled our track record together and put it into a database a year before going forward with the fund raise. That made the process that much easier," says Mr. Elowe. Anticipating the move to raise a fund should prompt operators to begin organizing well in advance to save time and expedite the process overall.

In addition to requiring a demonstrable track record, placement agents and potential limited partners will conduct independent due diligence on the track record. The track record must explain the basis for the calculation of the numbers which means disclosing the valuation methodology.[10] This can be time-consuming and may delay the fund-raising process in cases where the track record is extensive or the record-keeping is incomplete. To facilitate the due diligence process, fund managers should thoroughly document the various components of the record. "It is important that investors can see the life cycle of the investments," says Jahn Brodwin, a partner at the Schonbraun McCánn Group. This may include closing statements, initial capital, initial debt, operating statements, any interim financial, tax and audit statements and other pertinent information. Many funds hire professional accounting services to prepare an agreed upon procedures report on the track record in order to provide an additional degree of comfort to potential limited partners.

Potential fund managers must also ensure that they have legal authorization to use the information in the track record particularly since much or possibly all of what is presented results from previous joint ventures. When operators part from joint venture relationships, there may be some uncertainty over who the track records belongs to. Issues such as who managed the deal, who sourced the deal and who brought it to market etc.,[11] are all areas that are ripe for conflict. There may also be disputes over the bad deals as well which inevitably no one will want to take credit for.[12] To avoid any potential liability, managers should consult with legal counsel to ensure compliance with any confidentiality obligations resulting from prior deals.

For those operators without a track record, shifting from investing proprietary capital to a fully discretionary fund is often too big a step. A very logical interim step would be to do a series of joint ventures with a fund and work toward developing a solid track record of working with third party capital and reporting to third party institutions.

Financial Reporting

Many real estate operators have had little or no experience with the financial reporting requirements associated with managing an institutional fund. Financial reporting is all about transparency and providing investors with comprehensive information that details the fund's fiscal condition, its strategy and the methods by which it is executing its stated strategy.[13]

Requirements with respect to frequency of reporting may vary according to needs of the individual investors. Many institutional investors have stringent reporting requirements that the fund needs to comply with on a contemporaneous basis. "It's not unusual to raise a fund with 20 investors, half of which will require a standard monthly reporting package," says Mr. Brodwin. Some may even conduct due diligence to see if the fund has the kind of back office operation to handle such requirements, he adds.

Some funds may have the internal resources to handle financial reporting but many funds will outsource this function. Outsourcing solutions are an efficient way to handle financial reporting particularly for first-time funds that may not want to incur the extra costs associated with building internal capability. Mr. Brodwin recommends hiring a chief financial officer to serve as an investor relations coordinator who will primarily oversee the work of the outsource provider while the fund manager focuses on deal flow and other business matters.[14]

The other concern regarding reporting is the method used to evaluate financial information. "There is a bit of inconsistency in the industry right now with some funds reporting on the old historical GAAP and others reporting on fair value," says Mr. Brodwin. According to a recent study on trends in the private equity real estate market, new guidelines are being promulgated by the American Institute of Certified Public Accountants (AICPA) which offer guidance on funds that qualify as investment companies and those that do not.[15] Under the new guidelines, the funds characterized as investment companies will use fair value and the others will use GAAP.[16]

Conflicts

As a general matter, investors are cautious when investing in first-time funds and even more so when the operator owns and manages other competing properties and businesses. Investors will insist that the fund be the exclusive investment vehicle for investments that meet the fund's investment objectives and will be reluctant to invest their capital where the fund manger is distracted by other businesses and ventures. To pre-empt any potential conflicts, first-time fund managers should consider selling any competing businesses or dissolving any competing venture before raising the fund. Conflicts take on a life of their own in discussions with prospective limited partners and should be avoided if at all possible.

Conclusion

Ultimately, operators making the transition to first-time fund manager need to offer a sound investment strategy, a proven track record and the ability to add value in order to survive in the ultra-competitive real estate private equity market. Those possessing these qualifications and who commit to the business for the long term can become very successful fund managers.

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[1] "Real Estate Newsline Feature Story: Taking a Closer Look at the Real Estate Private Equity Market," (Ernst & Young Real Estate, Hospitality and Construction, New York, N.Y.), Fall 2005, at 1. [hereinafter "Taking a Closer Look"].

[2] Reyes, Jesse, "How to Be a Successful Emerging Manager for a First Time Fund: What LP's Think," Nov. 5, 2005, http://vcexperts.com/vce/university/seminar_view.asp?id=57.

[3] "Barron's Dictionary of Finance and Investment Terms" 147 (7th ed. 2006).

[4] "Market Outlook Trends in the Private Equity Real Estate Industry," (Ernst & Young Real Estate Hospitality and Construction, New York, N.Y.), Fall 2005, at 5. [hereinafter Trends].

[5] Id.

[6] "The Private Equity Business: More Work, Less Fun, Lower Returns," http://www.wharton.universia.net/index.cfm?fa=printArticle&ID=582&language=english.

[7] "Taking a Closer Look," supra note 1 at 1-2.

[8] Martha S. Peyton, Thomas Park & Fabiana Badillo, "Why Real Estate," (TIAA-CREF asset management, a division of Teachers Advisors, Inc.) Spring 2006, at 1, 7. http://www.tcasset.com/research/articles/docs/TCAM_Why_Real_Estate2006.pdf.

[9] "Top Things not to Include in Your PPM," (Fund Talk Updates and Issues Relating to Funds and Fund Management, Clifford Chance, London office) June 2006, at 2.

[10] Id. at 3.

[11] Reyes, supra note 2.

[12] Id.

[13] "Trends," supra note 4 at 5.

[14] Nadia Savone-Buonocore & Michael Lo Parrino, "Private Equity Fund Setup 101" (Ernst & Young Cross Currents) Issue 27, Fall 2006, at 23.

[15] "Trends," supra note 4 at 7.

[16] Id.

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