

## Fee for the taking

Opportunity funds sport higher fees to justify the process of searching for high-return investments. But to ensure your GP is earning those fees, limited partners can use a variety of tools.

By Aaron Lovell

An old cliché-cum-fortune cookie tells us that only great risk can yield great reward. The phrase holds a grain of truth, as do many pithy sayings, especially concerning the management fees for private equity real estate funds. Like many things in life, the more risk you take, the more reward you get—and, it seems, the higher management fees you can pocket.

The typical opportunity fund structure is set up to reward GPs for producing outsized returns. Historically, this meant a small management fee of 150 basis points, topped off with a twenty percent cut of the total profits after the limited partner has recouped capital. This fee structure, which has remained unchanged since the early 1990s, is based on the model found in traditional private equity partnerships.

Standard management fees for a real estate opportunity fund can range up to 200 basis points, according to Bob Lee, an attorney in Jones Day's Chicago office who heads the firm's Real Estate Funds practice.

Where a GP ends up on that management fee scale depends on a number of factors, including track record, investment strategy and geographic scope. For example, no matter how good your phone skills are, a private equity real estate pro can't chase deals all over the world with an international calling card and a fax machine. In funds that target assets around the globe or those covering a large geographic area, where overheads are inherently larger, fees can easily hit the higher end of the management fee range.

But fees can be negotiated lower, too, especially if you're a big investor committing a large amount of capital to a fund. That sort of commitment can give LPs more bargaining power and the opportunity to knock management fees down to a slightly more manageable 125 basis points.

For value-added or core-plus funds, which use less leverage and are less risky, fee structures are similar – if a bit lower – than those of the opportunity funds. Alan Braxton, a managing director and co-founder of Presidio Partners, a placement agent with offices in Chicago and San Francisco notes that management fees for value-added funds can range

between 100 basis points up to 150 basis points.

"The value-added strategy places an emphasis on current returns with a moderate amount of leverage, so you'll see lower investment management fees and lower promote structures," notes Braxton. "LPs incent you to do a good job, but the GPs are not expected to swing for a homerun."

Going one level down to core-type strategies, fees are based on the invested gross or the gross value of the portfolio, typically 100 basis points or less. While a small carried interest is sometimes offered to core managers, they make their living on current compensation, a key differentiating factor between core funds and those higher up the risk/return spectrum.

"The fees [opportunity fund] GPs get are really supposed to pay for their organization," notes Lee. "It's supposed to cover the people on the ground. It's not where they make their real money."

Braxton agrees, adding that the term of the investment can also influence higher or lower fees.

"An LP will say, 'Profits are going to be a little further out and hopefully greater, so I understand I might have to pay a little more in an annual investment management fee, just to keep your lights on,'" he explains.

As any sponsor will argue, the electricity bills do not pay for themselves. But if a fund underperforms, those bills take up a larger and larger percentage of the total return and an LP might ask what they are really getting for their money.

"As sponsors get larger and larger, LPs must make sure the management team is motivated to generate attractive, risk-based returns and not motivated to simply manage assets," Braxton cautions.

It is important, therefore, for LPs to follow their investments to make sure that the sponsors are seeking out opportunistic properties and adding value – not just playing with the financing on a core asset, collecting their fees and calling themselves an opportunity fund.

Lee says that the current market has allowed savvy opportunity funds to find core investments and rework the financing or use leverage to try to hit a 20 percent return. "Rather than picking up the glimmer in someone's eyes and really taking a risk for the big return, some investors have argued that GPs are buying trophy assets, leveraging them up and financially engineering higher returns," says Lee. "They have observed that in some instances, if the asset doesn't hit a 20 percent return, after the carried interest and the 1.5 percent management fee is paid, the net return to the investor looks more like a value-added or core plus return. These investors are asking, 'Why was that asset an opportunistic play?' All it did was make money for the sponsor."

Still, as Lee points out, not all of the data suggests that stable, class A properties are being passed off as opportunistic investments and, more importantly, the market continues to support the current fee structure. Any sort of fee reform will

most likely have trouble gaining traction until some of the largest investors begin to balk, but, then again, sizeable investors are often able to tweak the terms to their benefit, including management fees.

"Until [funds] have problems raising money based on the terms they're putting to market, those terms aren't going to change," Lee says, adding that first-time funds looking to establish their track records might have to show more flexibility in their fee structures.

"It's going to take several lead investors, \$250 million and up, to convince any large, global opportunity fund, who has been out to market and is now on their fourth, fifth, sixth or seventh fund, that their fee structure needs modification," he adds.

**Even if an LP** isn't a nationally recognized name with hundreds of billions in assets, they still have the power to exert some level of control over their private equity real estate investments. Investors can push to increase the transparency of a general partner through detailed reports, password-secured websites or advisory boards, as well as utilizing more active controls like "key man" provisions, increasing the alignment of interests with the fund's dedicated team and carefully choosing the preferred rate of return. By getting involved, investors can make sure their GPs are finding and executing an opportunistic strategy – and earning their fees.

But it is also important to utilize these controls sparingly, as too much oversight can handicap GPs. Lee says that more stringent investment guidelines can chip away at the flexibility and discretion LPs are paying their fund managers to exercise.

"It's an expensive service," he says. "If an LP wants to go out there and make their own investment decisions on an asset-by-asset basis, then they are over-compensating the sponsor. But they're also in the wrong vehicle."

Braxton suggests one way GPs can demonstrate that they're earning their money is through comprehensive and clear report-



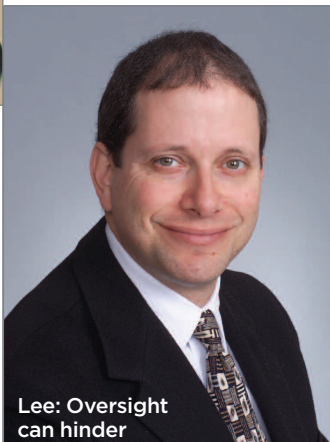
**Braxton: Reporting critical**

ing. "We have found that sponsors who do an exceptional job of reporting and communication with their LPs seem to have the true alignment of interests," he says. "Reporting is critical."

Braxton adds that LPs are beginning to focus on making the LP/GP relationship as transparent as possible, with the help of better reports and up-to-date information. "Years ago, it wasn't common to have these protected Internet sites

where you could log-in to your account with a sponsor and take a look at all the reports that are on the system, all the historical data. Those are very valuable tools."

Lee suggests that advisory boards are another way to increase a fund's transparency, providing a framework where information can flow to investors, conflicts of interest can be settled and on-going dialog can be maintained between investors and sponsors.



**Lee: Oversight can hinder**

When moving higher on the risk/reward continuum, talent becomes increasingly important, so LPs might want to review their relationship with their dedicated teams. Braxton points to "key man" provisions as useful tools. This often allows the LP to pull out their unfunded commitments if the fund's GP (or team of GPs) is no longer managing the fund.

Also, making sure the fund's dedicated team is cut in on the profits helps keep the interests of the LP and GP aligned, as well as ensuring that the rest of the investment professionals don't jump ship because they're not getting a piece of the pie. LPs should inquire as to how much of the promote the fund's dedicated team will receive, as well as how much capital the dedicated team is investing into the fund.

Both Lee and Braxton suggest that the preferred return rate can also be used to control how opportunistic a strategy the GPs will pursue. For example, a higher preferred rate, perhaps with a "catch-up," will lead GPs, who, in an opportunity fund structure are already working towards a 20 percent return, to execute riskier deals with a higher upside. With a lower preferred rate, LPs will usually see more moderate returns, less risky investments and a shorter timeframe on their investments.

But in the end, making sure a fund is pursuing the agreed upon high-return opportunity strategies – and thereby earning those higher fees – comes down to communication between investor and sponsor.

Braxton says, "The biggest carrots are the promotes and the fee structures, but, as in any other business, a successful relationship is ultimately based on trust and communication." ■

## Target IRR before and after management fees by fund strategy (%)

	CORE	VALUE-ADDED	OPPORTUNITY	ALL FUNDS
Target IRR before mgmt. fees	11.4	14.7	21.6	15.9
Target IRR after mgmt. fees	9.8	12.4	17.7	13.4
Differential	1.6	2.3	3.9	2.4

SOURCE: INREV, MGMT. FEES STUDY, 2005