LESSON 5 - FUND STRUCTURE – PART TWO

FUND ECONOMICS

1. The first consideration is the Promote.
2. The second consideration is Catch-Up.
3. The third consideration is the Claw back Provision.
4. The final consideration is the Committed vs. Invested Dollar In.

KEY DRIVERS FOR PROMOTES

There are six key drivers of the promotes. These drivers are listed below:

1. Co-Investment Amount
2. Pari Pasu vs. Subordinate Equity
3. Preferred Return (The Higher the Preferred Return, the large the back end split)
4. Income During Holding Period vs. Terminal Value Profits
5. Debt – Amount (80% or less is typical)
6. Borrower Recourse on the Debt

NOT ALL LPs ARE CREATED EQUAL

When considering the capital formation, it is important to remember that not all LPs are equal. We will group the LPs into two categories: The Lead LP and Other LPs.

For the Lead LP, the lead is the major investor in the fund. This should be a major investor that can raise more capital. They will also seek "special economic terms."

LEAD LP INVESTMENT RIGHTS

The Lead LP will have two main investment rights. The first involves Intellectual Capital. Your lead LP is/should be viewed as being smart, and as a result, will make it easier for other investors to get in behind your LP. Consider “Warren Buffet vs. your mother-in-law.” This takes a lot of pressure off your other LPs for due diligence.

The second right involves Preferential Economics. You will not receive the same fee and promote economics, which will probably be considerably less.

THE PLAYERS IN YOUR FUND: GPs vs. LPs

The Lead LP

Your major investor in your fund. This should be a major investment that can raise more money. They will seek “special economic terms”:
- Less management fees
- Less promote to you
- Investment committee approval
- An equity investment in the GP

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Preferred Return (7-10%)

Other LPs

These are passive investors who invest in your business strategy. These investors make up the core of your fund.
These investors will invest various amounts. You will have a minimum and maximum investment amount.

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Preferred Return (7-10%)

GP Fund Terms

General Partner Ownership:
- Who owns it
- Who seeks to get a piece of it:
  - Lead investors
  - Placement agents

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Asset Management Fee:
(Typically 1-2%. Can be based on committed or invested $ of capital)

GP Co-Investment

The Fund Managers Investment is measured in:
- Total Dollars the GP will commit
- Percent of the fun GP will commit to (i.e. 5%, 10%, 20%)

THE DUE DILIGENCE INTERROGATION PROCESS

As we have mentioned several times in this course, due diligence should be a top priority during this entire process. Due diligence should be a part of the interrogation process. During the due diligence process, there are four areas of concern. These are discussed below:

1. Track Record: Have you done this before? Do you deserve to manage this capital?
2. Your Term: Who is going to do the work? What is the progress? How do you all work together? Do you “love” each other?
3. Deal Flow (Part 1): How do transactions come to you? How do you source business?
4. Deal Flow (Part 2): Once a deal comes into your shop, how will you manage it?

LEGAL STRUCTURE

- Minimum Investment
- Subscription Frequency
- Lockup
- Redemption Notice
- Redemption Provision
- Gate Provisions
- Incentive Fee

WHERE THE MONEY IS

- High Net Worth Individuals
- Family Offices
- Insurance Companies
- Pension Funds
- Endowments

INVESTOR TRANSACTION SELECTION CRITERIA

THE KEYS TO SELECTING THE RIGHT SPONSOR	GUIDELINES FOR SPONSOR CO-INVESTMENT AMOUNTS
The sponsor, or owner / operator, in a commercial real estate transaction needs to be suitably qualified in the following areas:	**5% CO-INVESTMENT:** Not very desirable, as it creates an "option value" for the sponsor. Any investor who accepts a 5-percent co-investments would be well advised to make up for this low investment amount with additional structure.
INFRASTRUCTURE: Have the appropriate organization to take on the project	**10% CO-INVESTMENT:** Marginal; must have "going-in" merits that make the probability of success high.
CONSTRUCTION: Be qualified to manage the contruction needed to rehabilitate the property	**15% CO-INVESTMENT:** Normal and acceptable; a good starting point.
MANAGEMENT: Be qualfied to manage or oversee the day-to-day operations of the property and tenant marketing plan	**20% or MORE CO-INVESTMENT:** Indicates a sponsor who truly believes in the asset and business plan.
LEASING: Be qualified to oversee the leasing effort	
STAYING POWER: Having sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.	