ACPARE

CAPITAL FORMATION:

FUNDS vs JOINT VENTURE STRUCTURES

COURSE OBJECTIVES

1. Discuss the types of capital structure and provide an example of each.
2. Define a joint venture partner and provide examples of JV partners.
3. Compare and contrast the joint venture equity partnership and the fund structure.
4. Explain how to form a "good" partnership

LESSON 1 - START HERE

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

STABILIZED PROPERTIES

- Permanent financing
- Fully leased with rents at market rate and current cash flow within the properties
- No more work to be done on the property to “grow or groom” the NOI
- Lenders are betting that nothing “bad” will happen to the project cash flows in the future

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

UNSTABILIZED OR VALUE-ADDED PROPERTIES

- Shorter term or floating rate financing
- Not fully leased, and/or rents are not at market
- Substantial work to be done before the property becomes stabilized
- Something "good" needs to happen to the property cash flow in order to stabilize the property and achieve the business plan objectives

TYPES OF COMMERCIAL REAL ESTATE TRANSACTIONS

OPPORTUNISTIC PROPERTIES

- These properties typically require “specialized” financing.

TYPES OF CAPITAL (CAPITAL STRUCTURE)

1. First Trust Debt
2. Mezzanine
3. Equity High Leverage Mezzanine Preferred Equity
4. Hard Money/Bridge Loans/Distressed/Value-Added Financing
5. Debtor-in-Possession Loans (DIP)
6. Super Collateralized Loans (Super C)

LESSON 2 - JOINT VENTURE EQUITY – PART ONE

OPPORTUNISTIC FUNDS VS. JOINT VENTURE TRANSACTIONS

Opportunistic Funds vs. Joint Venture Transactions

There is a distinct and significant difference between a Fund Structure and a Joint Venture Structure. Some key points of differentiation are:

	Discretion	Promotes / Profits	Investors	Leverage	Crossed Promotes	Realization Timeline
Fund Structure	A Fund Structure has discretion to make investment decisions without approval from investors.	A typical fund promote structure is 1.5% management fee and 20% of the profits after a 9-10% hurdle.	A fund has a set group of investors.	A fund typically uses leverage, but must put all the assets of the fund up as collateral.	In a Fund Structure, the sponsor promotes (profits) are crossed, meaning that one bad deal can cause a loss of promote on the good transactions.	In a Fund Structure, the manager does not receive its promote until the last asset is liquidated.
Joint Venture Structure	A Joint Venture does not have discretion to make investment decisions without approval from investors.	A Joint Venture promote structure can vary dramatically. A typical Joint Venture structure might be: • 50bps Origination Fee • 1% Management Fee • 20% after a 10% Preferred Return • 30% After a 15% IRR • 40% After a 20% IRR	A Joint Venture will have different investors to each transaction.	A Joint Venture is typically leveraged at the asset level by project debt. In some cases the General Partner (sponsors) may have to guarantee the debt.	In a Joint Venture structure, promotes are not crossed, and each deal stands alone.	In a Joint Venture structure, the promote is paid out on a deal by deal basis, when that transaction is sold or refinanced.

JV EQUITY PARTNERS OVERVIEW

(UNDERSTANDING WHO THE PARTICIPANTS ARE)

Joint Venture Equity Partners

The General Partner

Also known as the sponsor. They are responsible for the day to day operations of the project and all decisions.

The success or failure of the project depends on the expertise of the General Partner.

Limited Partners

Passive investors with little or no say in the project's day to day operations.

They are along for the ride.

Institutional Equity

The big money partner. Looks for co-investment from General Partner which may include investment from the Limited Partner.

JV "PARI PASU" EQUITY

- Joint Venture Equity is also known as "pari pasu" equity.
- "Even Steven" equity, which means that all of this equity is treated equally.
- One of the keys to a successful JV "pari pasu" venture is to have an alignment of interests.
- This is the key to the appropriate equity structure.

JV "PARI PASU" EQUITY

Due diligence is a must for all possible JV investors. Questions that should be considered:

1. How is the ownership structured?
2. Where is the sponsor risk? (Cash equity, personal guarantee, etc.)
3. Who has the upside potential? How is this shared?
4. Who has the downside risk? How is this shared?

JV PROFIT PARTICIPATION OVERVIEW

- The sponsor's co-investment
- Co-investment amount from the general partnerships
- General Partnership equity subordinates or is pari pasu with Institutional Equity
- Sponsor promote

JV EQUITY WATERFALL: FULL SACK VS. NORMAL STACK

FULL STACK

- **FIRST TRUST LENDER:** Interest
- **FIRST TRUST LENDER:** Principal
- **MEZZANINE LENDER:** Interest
- **MEZZANINE LENDER:** Principal
- **MEZZANINE LENDER:** Kicker / Participation
- **EQUITY PREFERRED RETURN**
- **EQUITY PRINCIPAL INVESTMENT**
- **PROFIT SPLIT FORMULA**

NORMAL STACK

- **FIRST TRUST LENDER:** Interest
- **FIRST TRUST LENDER:** Principal
- **EQUITY PREFERRED RETURN**
- **EQUITY PRINCIPAL INVESTMENT**
- **PROFIT SPLIT FORMULA**

- Straight Line Participation of Profit
- Look Back IRR
- Fixed Exit Fee
- IRR Waterfall

JV PROMOTE STRUCTURES

CURRENT PAY

With Current Pay, the project needs to have cash flow from the beginning. Usually, there would be a quarterly payout to the participants.

ACCRUAL PAY

With Accrual Pay, the return is not paid current. Instead a balance is built up and paid back before return of capital.

LESSON 3 - JOINT VENTURE EQUITY – PART TWO

JV METRICS TO UNDERSTAND

IRR - IRR is the internal rate of return for the entire project.

GROSS RETURN MULTIPLE - The Gross Return Multiple is the private equity measurement that will value the return paid to an investor.

TOTAL DOLLAR PROFITS - The Total Dollar Profits is the actual profit amount that each participant will receive from the deal.

JV PUNITIVE CLAUSES FOR OPERATING PARTNERS

For every JV deal, there are punitive clauses for the operating partners.

1. Cash Equity vs. Market Equity
2. Control Shifts
3. Claw Backs
4. Additional opportunities

JV PROFIT PARTICIPATION STRUCTURES

Straight Line Approach	IRR Look-Back Approach	Fixed Exit Fee	IRR Waterfall

JV RESIDUAL STRATEGIES FOR EXISTING JOINT VENTURE DEALS

Mandatory Sale	The Shotgun Approach	Appraisal Buyout Method

LESSON 4 - FUND STRUCTURE – PART ONE

INTRODUCTION

When a fund structure is considered, there are five investor transaction selection criteria.

1. Numbers
2. Sponsorship
3. Alignment of Interests
4. Key Events
5. Back-Up Plan

WHAT IS PRIVATE EQUITY

Investee Management	Debt Management	Exit	Investor Management	Regulation

CAPITAL FORMATION: CALLING THE CAPITAL

The first step in capital formation is to "call the capital."

The second option is the Pledge Fund.

The third option is Fully-Funded Fund.

CAPITAL FORMATION: BUSINESS STRATEGY

Fund Purpose	Investment Strategy	How Will You Make Money?	Your Edge

CAPITAL FORMATION: FUND INVESTMENTS

Investment Matrix	Investment Committee	Blind Pool vs. Portfolio

FUND RETURNS

Gross Returns	Net Returns	Multiples

FUND TERMS

Term of Fund	Call Provisions	Capital Call Default	Distributions

COMMONLY USED TERMS

As you gain experience in the industry, it is important to know the commonly used terms within capital formation.

- Recycling: How long are calls good for? Can you reuse money after distributions?
- Investment Period: How long the investment manager has to deploy/invest the money.
- Term of Fund: How long is the life of the fund?
- Distributions: Paying the LPs. How often will they be paid? What constitutes a capital event that will trigger a distribution?

INSTITUTIONAL RULES OF ENGAGEMENT

1. Better Be Ready to Execute: "Use it or lose it." Better have a "pipeline" of potential deals.
2. Most Institutional Investors Generally Favor Smaller Funds That Live Off Incentive (and Not Management) Fees: Counter argument that high compensation attracts the best players.
3. Consistency of Track Record: No "pass" for financial crisis.
4. Team That Loves Each Other and Works Well Together: Cohesion
5. Diligence of Downside Cases: Using good "robust" models. Structure away the risk. Sponsors/Funds with track record buoyed by home runs to offset losers that are unattractive.

POSSIBLE FUND STRUCTURES

- Private Capital With Delicated Allocation
- Institutional Capital Alignment
- Fund Joint Venture/Facility
- Classic LP Structure

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.	

LESSON 6 - UNDERSTANDING HOW PARTNERSHIPS WORK

PARTNERS OR FRIENDS

Married or Life Partner (Domestic-Sense): Share a bed and/or checking account.

Business Partner: Share a checking account.

Partners in your business: Who stands to benefit from this partnership? Which benefits does the other person bring to the table? Is this really outsourcing administration type work? If not, hire an intern!

1.2 HOW TO CREATE A GREAT PARTNERSHIP

THERE ARE FIVE STEPS TO CREATING A GREAT PARTNERSHIP.

1. Allocate each partner's ownership rights according to "shared expectations and commitments."
2. Partner compensation and incentives are based on partner contribution.
3. Put one person in charge. The Navy doesn't have co-captains on their ships and neither should you!
4. Get a partnership in writing in the form of an operating agreement.

Trust is the bedrock for a great partnership.

ASK THE HARD QUESTIONS

WHEN FORMING THE PARTNERSHIP, IT IS IMPORTANT TO ASK THE HARD QUESTIONS. LET'S REVIEW THE KEY QUESTIONS BELOW:

1. How are they currently earning a living now and paying their bills?
2. How will they add value? Have them explain in detail.
3. What professional or work experience do they have?
4. You are not the first or last guy to knock on the door, so why you?