

❖ *Carried Away: Removing Distortions Created by Traditional Carried Interest Mechanisms*

Introduction

Incentive compensation can be an extremely powerful tool. In recognition of this fact, investors in a typical private equity real estate fund customarily give 20% of the fund's expected profit to the manager as a carried interest, the purpose of which is to motivate and retain talented teams.

Unfortunately, incentives do not always work as intended. A traditional carried interest structure can distort and even invert a manager's motivations. Thoughtful manager selection (identifying dedicated teams that are focused on building a track record and creating long-term franchise value rather than on collecting their next fee) can help overcome these distortions. But even the best teams are more focused on the true benefits and costs of their decisions when their personal financial interests are at stake.

Allocation of profits may not be on the forefront of everyone's mind at a time when commercial real estate is undergoing an unprecedented correction (with NPI derivatives now predicting peak-to-floor appreciation near -40%). But the difficult fundraising environment that has resulted also creates an opportunity for investors to re-examine the mechanisms that they use to compensate and motivate their managers. Used thoughtfully, this opportunity can be more than a way for investors to reduce fees as much as possible while negotiating leverage has shifted in their favor. Instead, it can be used to create fair and rational compensation structures that can endure through cycles. Improving alignment through the carried interest is one key element of that effort.

Traditional Carried Interest

In private equity real estate funds (and in buyout funds and venture funds), the carried interest rarely deviates from 20% of the fund's net profit. The carried interest is generally subordinated to a preferred return that ranges from 8% to 10% per year, which is then unwound by a "catch-up" that shifts distributions in favor of the manager until the manager has received 20% of the overall net profit (effectively wiping out the impact of the preferred return). Any additional profit is then shared 80/20. A depiction of a typical waterfall's impact on carried interest shown in Exhibit 1 (next page).

With this structure, small changes in a fund's gross performance can cause a manager's carried interest compensation to swing wildly, creating some unintended incentives. These changes are aggravated by the fact that a typical carried interest structure rewards a manager with a full 20% of the fund's profit

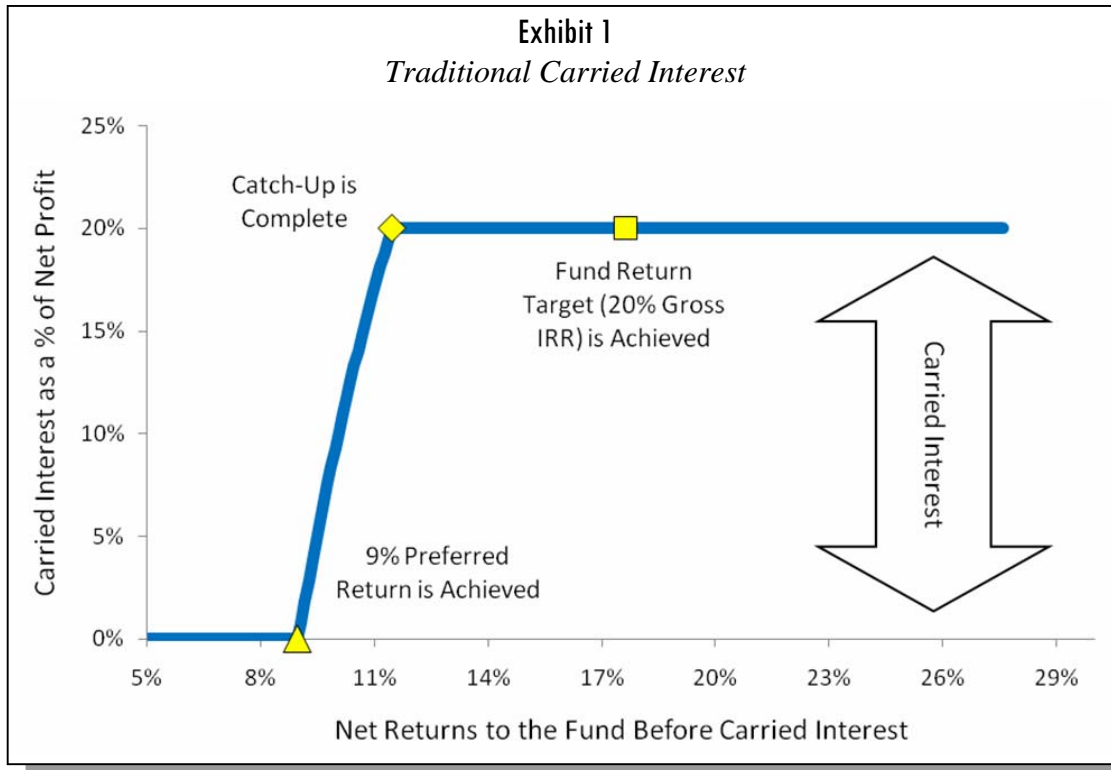


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even if the fund falls well short of its stated target.

The Incentive to Take Too Much Risk

Because the carried interest allows a manager to share asymmetrically in a fund's profit, it creates an incentive for the manager to select riskier investments than it would have selected if it were investing solely for its own account. This basic conflict is widely understood, and requires little attention.

The Incentive to Take Too Little Risk

Less intuitive (and much more interesting) is the potential for carried interest to drive a manager to be too risk-averse. If a manager is just past the catch-up layer of its waterfall (just to the right of the yellow diamond in the graph above), the situation described in the previous section reverses, and the manager bears a disproportionately large share of any downside. In this circumstance, a manager may decrease risk by avoiding opportunities that investors would consider to be attractive. This can

manifest itself in three ways: (i) by the manager selling promising projects too early, (ii) by the manager investing too little (either by terminating the fund's investment period without deploying all of the available capital or by declining to use its option to reinvest proceeds from realizations) and, (iii) by the manager selecting investments with expected returns that are too low.

Exhibit 2 (next page) depicts a situation in which a traditional carried interest mechanism causes a project with an attractive expected return for the fund to actually generate a negative expected return for the manager.

The Incentive to Make Dilutive Investments

Once a fund has generated enough profit that the manager is unlikely to slide back into the catch-up layer of the waterfall (generally represented by the area to the right of the yellow square in the graph above), the incentive created by the carried interest shifts. Rather than driving the manager to generate a combination of IRR and multiple, the manager now has a financial incentive to create only multiple. At this point, it receives 20% of all additional profit no matter

Exhibit 2
Possible Outcomes of a Hypothetical \$100 Investment by a Fund that is Just Past its Catch-Up

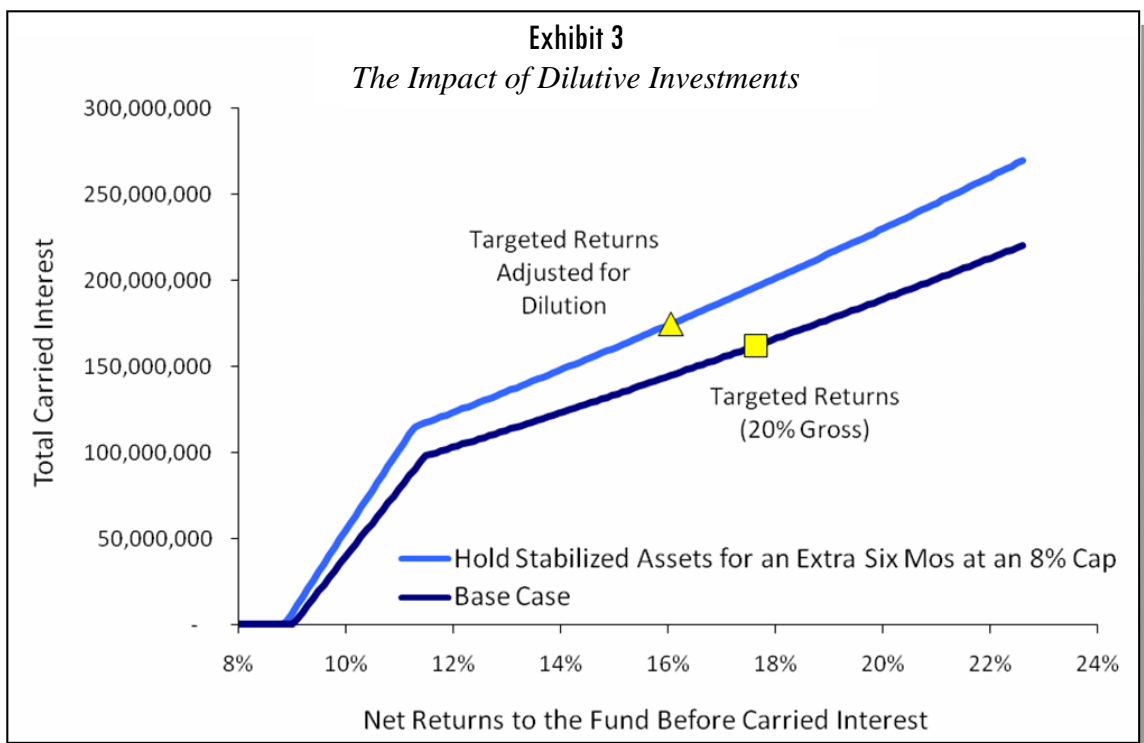
	1.6x Multiple 50% Chance	0.8x Multiple 50% Chance	Total Expected Return
Profit to the Fund	\$60.0	(\$20.0)	\$20.0
Profit to the Manager	\$12.0 (20% of additional profit as a carried interest)	(\$14.0) (70% of losses as the catch-up is unwound)	(\$1.0)
Profit to Investors	\$48.0 (80% of additional profit)	(\$6.0) (30% of losses as the catch-up is unwound)	\$21.0

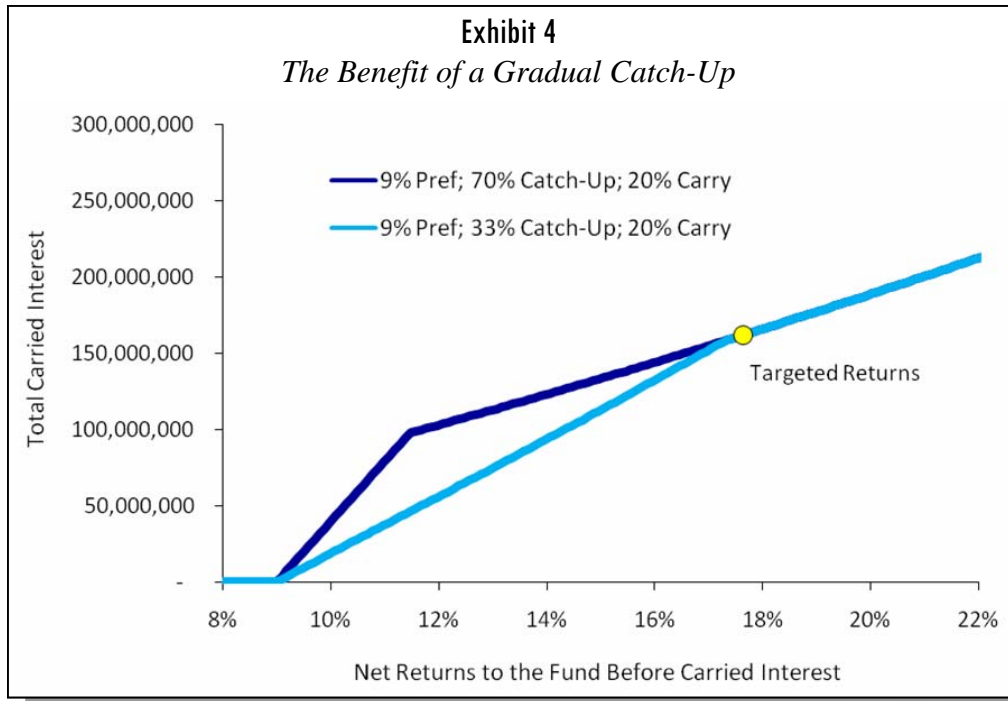
how dilutive an investment may be (as long as investments aren't so dilutive that they push the manager back into the catch-up layer of the fund's waterfall). The need to maintain a track record tempers this incentive, but its effect diminishes once the fund is comfortably past its targeted return.

This incentive can manifest itself in two primary ways. First, if a manager has sufficient visibility into the overall performance of the fund before expiration of the investment period, it can "recycle" any distribution proceeds, effectively increasing the size of the fund. In this case, the

manager is all but guaranteed to receive 20% of the profit on these investments. The incentive is to put as much capital to work as possible, not to put it to work as effectively as possible.

Second, a manager can hold investments past stabilization, receiving a 20% incentive fee on income generated by core assets. Exhibit 3 shows the impact of holding all assets for an additional six months past stabilization. Although the overall IRR is diluted, the total carried interest increases because the fund generates more profit dollars.





Solutions

Each of these distortions is driven or aggravated by a common element: the presence of a steep catch-up at relatively low levels of performance.

A customary solution (sometimes referred to as the “foundation model”) is to eliminate the catch-up and either reduce the preferred return or increase the base carried interest. On balance, this is an appealing approach. But it does have some drawbacks. Reducing the preferred return allows the manager to receive incentive compensation at even lower levels of performance than the current model. Increasing the base carry can result in massive amounts of carried interest being paid for results that may be driven only in part by a manager’s efforts. For example, a strategy (designed for a different part of the market cycle) of investing in emerging market developers and exiting through the public markets or a strategic sale is likely to be either a wild success or a failure based, in large part, on the condition of the public markets late in the fund’s lifecycle. A higher base carried interest would allow a manager to capture upside that was generated as a result of additional risk taken by investors, not by its own skill or effort.

Preferable solutions exist. One is to use a two-tiered preferred return to delay the catch-up. This helps ensure that a manager receives the full 20% carried interest only after it has come reasonably close to achieving its targeted returns, but it doesn’t solve the fundamental alignment problem created by the traditional catch-up.

An even better – and simpler – solution is to simply reduce the rate of the catch-up. Moving the catch-up from the traditional range of 50% to 80% down to around 30% would result in (i) the manager receiving the full carried interest (in percentage terms) only when the fund reaches its targeted return (assuming a 20% gross target and standard management fees), (ii) substantially temper the distortions created by a traditional catch-up (since the catch-up rate isn’t much different than the 20% base rate), and (iii) avoid the potential for the carried interest to balloon if market conditions are favorable. (See Exhibit 4.)

This approach can also serve as an important signal to investors, demonstrating the manager’s confidence in its ability to deliver targeted returns.

Other Considerations

The construction of a fund’s carried interest is one element of a package that determines the

overall alignment of investor and manager interests. The dispersion of the carried interest among the management team, the vesting schedule for individual team members, and the timing of the carried interest (i.e., a back-ended waterfall vs. a fully-pooled waterfall) all play important roles. The relative importance of these factors varies based on the fund's strategy, the manager's existing incentives, and a variety of other factors. But the basic carried interest mechanism is critical because it lays the foundation on which the entire incentive package is built.

Conclusion

The current dislocation in the real estate markets presents an extremely attractive opportunity for investors who have capital to invest, a well-designed investment plan, and the ability (and discipline) to execute their plan. The current stagnation in the capital raising markets creates a further opportunity to drive returns by creating the right incentives in a particularly volatile market and by helping to screen out managers who signal a lack of confidence in their ability to deliver their targeted returns.

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