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**OPPORTUNITY FUND  
FEE STRUCTURES  
IN A CHANGING MARKET**

*November 2005*

The Townsend Group  
*Institutional Real Estate Consultants*  
*Cleveland, OH   Denver, CO   San Francisco, CA*

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### INTRODUCTION

A tremendous flood of capital has entered the real estate markets over the past several years, elevating property values in many markets and allowing many funds to generate attractive returns. Opportunity funds, employing a variety of high-return strategies, have benefited from this market dynamic.

To a large extent, the recent capital surge has been the result of low interest rates and an overall economic expansion. However, few expect capital flows and returns to remain so robust with interest rates rising. One sign of lowered expectations is the fact that many of the managers that are currently raising new funds have proposed lower preferred return thresholds and steeper catch-up provisions than they have used in the past. These changes would allow them to receive incentive-based compensation at relatively low levels of fund performance.

We believe that thoughtful investing in the opportunity fund sector can continue to provide investors with attractive risk-adjusted net returns. However, changing market conditions and evolving fund terms and conditions make it more important than ever for investors to be diligent in evaluating managers, strategies and fund terms and conditions.

### TYPICAL OPPORTUNITY FUND FEE STRUCTURES

Different managers, investors and consultants use different terms to describe various investment strategies. We consider opportunity funds to be those real estate investment vehicles that seek to achieve high overall returns (generally 18% or more after most fund expenses but before investment management fees and carried interests) by pursuing investments that have inherent underlying value but that may be underperforming due to factors such as poor management, the unavailability of capital, market cycles or the need for the underlying properties to be developed, redeveloped or repositioned. Opportunity funds are typically expected to provide little or no current income to investors (although there are exceptions) and usually employ significant amounts of leverage (generally 50% or more). Because this fund category targets the highest overall returns, it is no surprise that it also tends to be fairly expensive relative to other real estate fund classes.

Opportunity funds vary both in their actual terms and conditions and in the terminology that they use to describe those terms and conditions. Taken together, these facts can make it difficult for investors to draw meaningful comparisons among different funds. However, it is possible to make some generalizations using our own terminology.

*Investment Management Fees.* Opportunity fund managers typically receive an annual investment management fee for deal sourcing and evaluation, fund-level reporting and other administrative functions. These fees typically range from 1.0% to 2.0% of committed capital during the fund's investment period, and from 1.0% to 2.0% of invested capital (*i.e.*, the cost basis of unrealized investments) after the investment period ends.

*Distributions and Carried Interest.* Most opportunity funds return all capital contributions to investors (which includes the general partner to the extent of its capital commitment), along with a preferred return in the range of 8% to 10% per year, before the general partner begins to share in the fund's profit. After the preferred return, the general partner typically receives accelerated distributions (generally 50% to 80% of incremental cash) until it has received 20% of the fund's distributed profit as a carried interest (or promote). Additional distributions are then split 80% to the investors and 20% to the general partner as an additional carried interest. A minority of funds allow their managers

## OPPORTUNITY FUND FEE STRUCTURES IN A CHANGING MARKET

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to share in the profit earlier, by using distribution mechanisms that allow carried interest to be distributed after the fund has returned only the capital contributions made to fund previously realized investments and a portion of the contributions made for other purposes, along with a preferred return on only those amounts.

*Property Management Fees.* Many funds also pay property management fees (either directly or through portfolio companies) to obtain management, construction, leasing, development and other property management services from affiliates of the fund's manager. These fees are typically required to be set at market rates, so they generally do not represent an additional cost to investors.

*Acquisition Fees.* Some fund managers also charge acquisition fees (which are often paid by portfolio holding companies but borne indirectly, at least in part, by investors). As a result of investor resistance, many funds now apply a portion of any acquisition fees to offset their investment management fee.

*Asset Management Fees.* Fund managers generally provide assistance to the managers of individual fund assets. This assistance can include participation in budgeting, strategy, debt financing, reporting and other matters. Traditionally, these services have been covered by funds' investment management fees. However, two exceptions have developed. First, in the past fifteen years, some managers have moved away from providing these services and now outsource asset management functions to operating partners. Second, other managers have begun charging separate asset management fees for these services. In some cases, these fees are charged directly to portfolio holding companies, in which case a portion might be applied to offset the investment management fee. In other cases, the fees are charged directly to the fund.

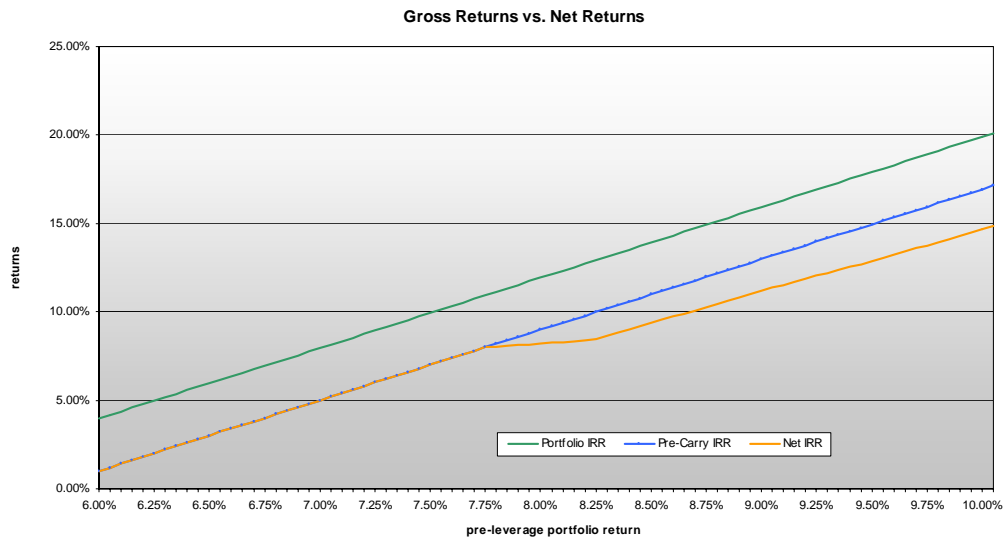
By comparison, core (or stable) funds typically have a fee based on net asset value (typically 100 basis points per year or less), which is occasionally accompanied by an incentive fee that is far less than the incentive fee that we observe in opportunity funds. Enhanced return funds have traditionally employed acquisition fees and investment management fees based on invested or committed capital, accompanied by an incentive-based fee. Enhanced return incentive fees vary significantly, but are typically more modest than those used in opportunity funds. One of the principal differences is that enhanced return funds often do not have a catch-up.

### THE EFFECT OF FEES ON RETURNS

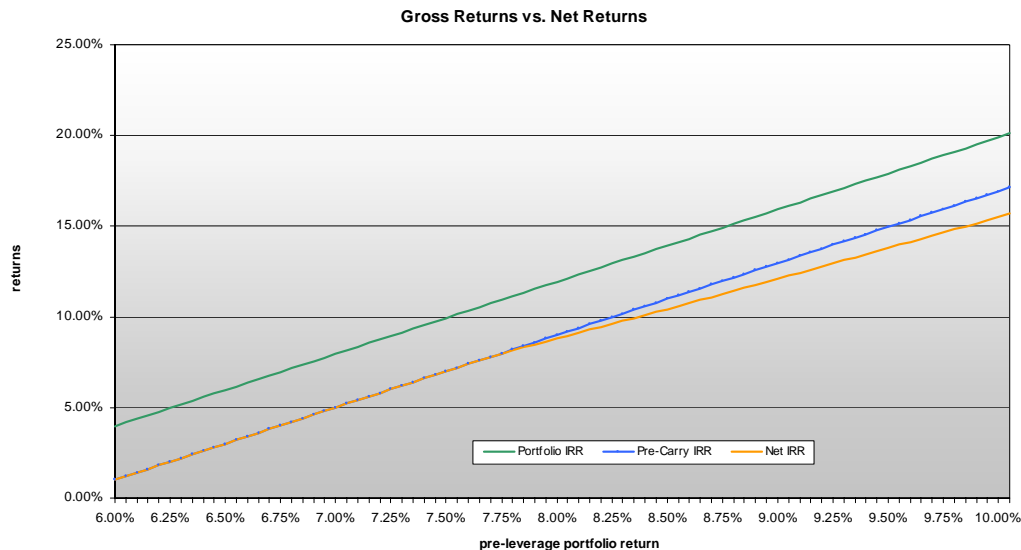
We frequently hear managers reference their superior performance. However, more often than not, their track record is reported without giving effect to fund-level fees and expenses and before accounting for the manager's carried interest. Consider the following. A very successful manager recently stated that it made an investment that will return 21%. This sounds terrific, but by the time the operating partner receives its promote, the investment manager receives its fees (including the carried interest) and the fund's other expenses are paid, the expected net return to the investor is approximately 13%. The fees and costs are 8%. We know that real estate is an inefficient asset class, but this example begs the question – is it so inefficient that the investor is properly being rewarded for the additional risk that it incurs when it pays nearly 40% of the total return in fees and expenses? And this illustration does not account for additional taxes or other expenses that may flow through to investors if an investment is offshore.

## OPPORTUNITY FUND FEE STRUCTURES IN A CHANGING MARKET

The accompanying graph depicts, across varying levels of performance by a fund's underlying portfolio, the differences in (i) gross returns generated by the fund's portfolio, (ii) net fund-level returns after fees and expenses but before carried interest and (iii) net returns to the investor. For example, on the far right side of the graph, the fund's underlying portfolio is generating a gross IRR of just under 20%, the fund itself is generating a return (net of fees and expenses but before carried interest) of just over 17% and the investors are actually receiving an IRR of only 14.75%. The graph uses assumptions that would be typical of the more aggressive opportunity fund fee structures that we are seeing in the marketplace, including an 8% preferred return and an 80% catch-up.



For the sake of comparison, the following graph shows the same fund without a catch-up for the general partner. This structure would be more typical of an incentive fee in the enhanced return sector.



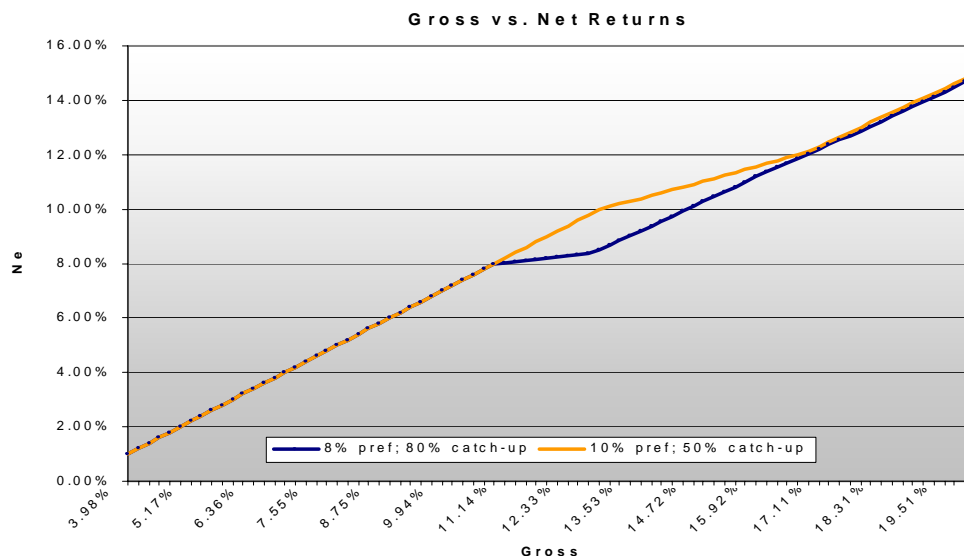
## KEY ISSUES TO CONSIDER

The discussion below highlights some of the key issues to consider when evaluating an opportunity fund's fee and expense structure.

### 1. Consider the Effects of Reduced Preferred Returns and Accelerated Catch-Ups.

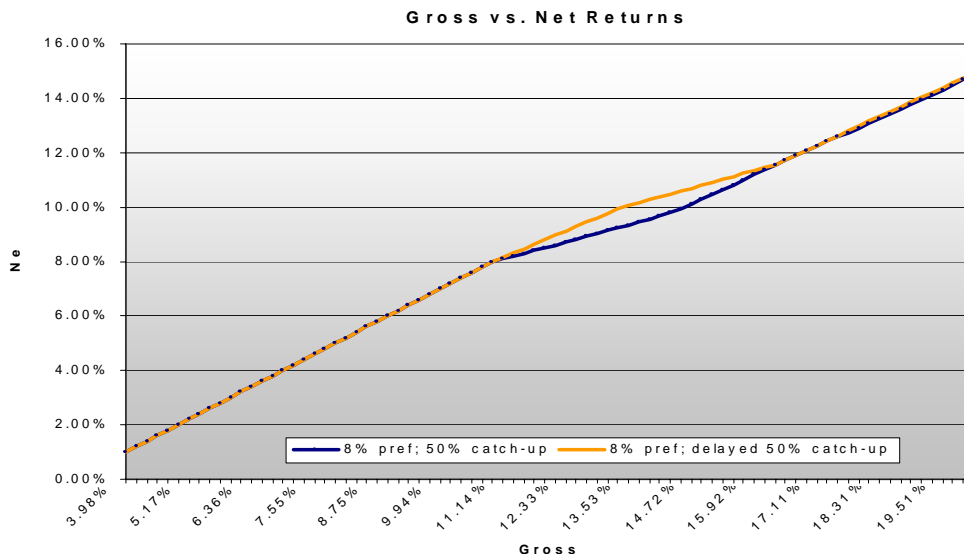
Both managers and investors begin with the assumption that a fund will generate overall profit sharing of 80/20 between the investors and the manager. Underlying this assumption is an expectation that a fund will exceed its preferred return threshold and generate enough additional profit to move beyond the catch-up layer of its distribution waterfall. On the heels of significant cap rate compression, and with interest rates that appear poised to rise, funds may be unable to generate the kind of profit needed to exceed 10% hurdles and work through gradual catch-up provisions. Not surprisingly, we have begun to see managers reducing preferred returns from 10% to 8% and increasing the general partner's catch-up from 50% to 80%.

The following graph demonstrates the difference in net returns generated by (i) a fund with an 8% preferred return and an 80% catch-up and (ii) a fund with a 10% preferred return and a 50% catch-up. Both funds have a 20% carried interest.



There is, of course, a need to balance competing interests carefully. A distribution mechanism that is too conservative may not generate the kind of short-term incentives needed for a fund's manager to attract and retain a talented management team (particularly at junior levels, where individuals who may not have accumulated much personal wealth might be anxious to participate in the carry). When it is appropriate for a general partner to begin receiving carry at relatively low levels of fund performance, we often propose a two-tiered preferred return. After the investors receive the first preference, the general partner takes 20% and the investors take 80% of any additional profit until the investors have received an amount equal to the second-tier preferred return. The catch-up takes effect only after the second-tier preferred return has been achieved. The accompanying graph demonstrates the net returns generated by a two-tier preferred return (8% for initial sharing and 10% for the catch-up to take effect),

compared with the net returns generated by a straight-8% preferred return. In both cases, the catch-up is 50/50.



**2. Understand a Fund’s Basic Distribution Mechanics Thoroughly.**

Net returns to investors can be impacted significantly by seemingly mundane allocation and distribution mechanics. For example, in one draft partnership agreement that we recently reviewed, the distribution section contained a short proviso that caused the fund’s investment management fees to be paid by offsetting distributions that would otherwise have been made to the investors. Because management fees were deducted *after* the carried interest had already been determined, this provision artificially inflated the amount of cash that was run through the waterfall and thereby increased the general partner’s carried interest. This technical and seemingly unimportant provision (which was removed at our request) would have cost investors an estimated \$6 million over the life of the fund.

There are many other ways in which technical provisions can have a significant effect on investors’ returns. Anomalies in allocation provisions can (in extreme cases) override clawback obligations. Generous (or even overreaching) tax distribution provisions can erode otherwise strong protections against over-distribution to the general partner. Variations in preferred return computations can affect hurdles significantly without affecting nominal rates.

While we believe that these types of provisions rarely represent an effort to mislead investors, it is obviously important for investors to identify these nuances and understand the effect that they can have on net returns.

**3. Consider the Cost of Asset Management Services.**

In addition to the investment management fee, some fund managers charge a separate asset management fee for assistance that they provide to the managers of individual fund assets. Although fund managers generally do provide meaningful asset management services (with some of them even having

dedicated asset management teams), these services have traditionally been covered by investment management fees.

When separate asset management fees are charged, they may show up either as a direct fund expense or as an expense of a portfolio holding company. This fact can complicate cross-fund comparisons. Between two funds with identical asset management fees and identical overall performance, the one with the fund-level fee would report a relatively high gross IRR (since portfolio performance would not be affected by the asset management fee) but relatively high fund-level fees. The evaluation of asset management fees is further complicated by the fact that some funds offset a portion of the asset management fee against their investment management fee, while others do not.

There is nothing inherently wrong with a separate asset management fee. In many cases, it may represent nothing more than an attempt to itemize a part of the manager's compensation. However, because the asset management fee can serve as an additional profit center for managers, it can also increase total expenses for fund investors. Accordingly, it is important to analyze and understand its impact.

Other managers do not charge an asset management fee, but outsource some of the asset management services that would have traditionally been covered by the investment management fee. The use of operating partners to provide a combination of asset management and property management services can give a manager a concentrated level of expertise without internally changing its infrastructure. However, this benefit comes with a price for investors. In our experience, managers that take a more active role in the monitoring and oversight of individual investments are able to control costs better than managers that outsource asset management services. To a large extent, this is due to the fact that many operating partners require a share of the profit that is generated by the properties that they manage. Of course, unlike the fund-level carried interest, the profit paid to operating partners is not netted against fund-level losses and expenses. As a result, investors might indirectly bear significant incentive fees, even before overall fund performance crosses the preferred return threshold.

#### ***4. Consider the Effect of Both Direct and Indirect Fees and Expenses.***

In addition to the cost of investment management and asset management services, there are several other direct and indirect expenses that contribute to a fund's total expense level. For example, one fund that we reviewed has a very low investment management fee, but reimburses its manager for a significant portion of the manager's own overhead costs, including portions of the compensation paid to its most senior personnel. At first glance, the fund's low management fee seems attractive when compared with the fees that must be charged by managers that employ more traditional fee and expense structures (under which the manager's overhead costs are paid out of the management fee). However, closer analysis of the costs as well as the fees reveals that the fund is actually relatively expensive.

This is just one example of how structural variations and the fungibility of certain fees and expenses can make it difficult to draw meaningful comparisons among funds. The same basic expense might show up as a fund-level fee in one fund, a fund-level expense in another and a portfolio-level expense in a third. As a result, different funds might produce identical net IRRs for investors, but report very different fee loads and very different gross IRRs.

Property management fees can be particularly difficult to evaluate. To a large extent, they represent a necessary cost of doing business, and would have to be paid to independent third parties if not paid to the manager or one of its affiliates. So, to the extent that these fees are set at market rates (as is typically

required), there is really no difference between a fund that charges a property management fee and one that does not. However, the one that charges the fee might look substantially more expensive at first.

Unlike property management fees, acquisition fees are generally not required to be set at competitive market rates. Although other justifications for these fees are often given (such as the fact that managers provide investment banking services to portfolio holding companies), the reality is that these fees can operate as an additional profit center for the manager (increasing the expenses that are ultimately borne by investors). In many cases, managers apply a portion of the acquisition fees that they receive to reduce their investment management fees. The key here is understanding the extent to which the net acquisition fees increase the ultimate cost of a fund for investors, taking into consideration (i) whether the fees are being paid in exchange for services that would otherwise have been acquired from third parties, (ii) whether any portion of the acquisition fees are offset against the investment management fee and (iii) the secondary effects that acquisition fees and offsets can have on distribution waterfalls.

### 5. *Evaluate the Risks of Over-Distribution.*

Although preferred returns, catch-ups and carried interest rates drive a fund's core economics, they do not paint the entire picture for investors. The timing of distributions can also have a meaningful effect on investor returns.

A fund that returns all capital contributions up front can generate a very different result for investors than one that does not. The latter is much more likely to result in over-distributions to the fund's general partner. Although most fund agreements contain provisions that require general partners to return excess distributions that they have received, those "clawback" mechanisms often have many shortcomings that can leave investors exposed to the risk that interim over-distributions to the general partner will become permanent and ultimately distort the fund's basic economic deal.

To take a very simplified example, assume that there are two funds that perform identically and have identical terms, except that one of them returns all capital contributions to investors and pays a preferred return before distributing any carried interest (referred to below as a full return waterfall), while the other returns only the capital contributions made to fund previously realized investments and a portion of the contributions made for other purposes, along with a preferred return on only those amounts (referred to below as a partial return waterfall). Assume that the funds each (i) call \$200 from their investors and use the proceeds to make two \$100 investments, all on the same day, (ii) sell the first investment for \$210 the following day and (iii) sell the second investment for \$20 on the third day. Both funds generate a net profit of \$30 (representing profit of \$110 from the first investment and a loss of \$80 from the second).

*Full Return.* When the first fund sells its first investment for \$210, it will return all \$200 of capital contributions before dividing the remaining \$10 between the general partner and the investors, with the general partner receiving carried interest distributions of \$2. (For simplicity, we are using short time periods that make preferred returns and catch-up provisions irrelevant.) When the fund sells its second investment for \$20, the general partner will be entitled to an additional \$4 (or 20% of the incremental cash). Of the fund's cumulative net profit of \$30, the general partner will have received \$6, or 20%.

*Partial Return.* When the second fund sells its first investment, it will return only \$100 to investors (representing the capital contributed for that investment) before dividing the remaining \$110 be-

tween the general partner and the investors. The general partner will receive carried interest distributions of \$22 (or 20% of the remaining \$110). When the second investment is sold, the entire \$20 will be distributed to the investors. However, on a cumulative basis, the general partner will have received excess carried interest distributions of \$16 (representing the \$22 in carried interest distributions previously paid to it less the \$6 that it is ultimately entitled to receive based on the fund's actual net profit of \$30). If the fund had a standard after-tax clawback and an effective tax rate of 41%, the general partner's clawback obligation would be limited to \$13 ( $\$22 \times (100\% - 41\%)$ ), leaving the general partner with a carried interest of \$9 (\$22 less the maximum clawback of \$13), or 30% of the fund's net profit.

A fund with a partial return waterfall can generate results that are even more extreme than the one described above. If that type of fund generates significant cash from portfolio operations, no capital return obligation is triggered because no investment has been realized. As a result, the cash bypasses both the capital return layer and the preferred return layer of the waterfall (assuming no deficiencies from prior dispositions) and is applied toward the general partner's carried interest.

In reality, most funds either adopt the full return approach or use some other mechanism to lessen the risk of over-distribution. For example, many funds with partial return waterfalls restrict distributions of carried interest if the fund has significant unrealized losses. While these devices are helpful, they do not eliminate the risk of over-distribution, particularly if early investments are sold before losses in the remaining portfolio are identified. In addition, although these protections are common, they are not universal. It is important to review fund distribution mechanics carefully and to evaluate any risk of over-distribution.

Most funds use clawbacks to correct, or at least mitigate, over-distributions. Although these devices should be included in any fund that presents a risk of over-distribution, they are particularly important in funds with partial return waterfalls.

A clawback provision should be triggered by *either* (i) the general partner's carried interest representing more than 20% of the fund's net profit *or* (ii) the returns to the limited partners falling below the preferred return threshold after the general partner has already received carried interest. The second prong is necessary in case diminishing performance late in a fund's life causes investor returns to slip below the fund's preferred return threshold, but without the level of loss necessary to trigger the first prong of the clawback. While two-pronged clawback mechanisms tend to dominate the landscape, there are some sizeable funds with clawbacks that are triggered only by excess carried interest distributions.

A clawback has value only to the extent that it can actually be enforced. Because the general partner is a limited liability entity, a meaningful guaranty is necessary for limited partners to ensure that they will have some recourse.

### **6. Consider the Size of the Management Fee Base.**

In general, an investment management fee is charged as a percentage of committed capital during an opportunity fund's investment period and as a percentage of invested capital (*i.e.*, the cost of unrealized investments) thereafter. There are, however, variations that can affect the amount of management fee that is ultimately borne by investors.

We recently reviewed two funds that had post-investment period management fees that were based not on invested capital but on *all* capital contributions minus only those distributions that represented a return of capital used to fund investments. This is different from a typical fund structure, which bases the management fee in the post-investment period on the capital used to make unrealized investments. Assume that investors contribute \$85 to a fund for investments and contribute another \$15 for management fees and other expenses. In a typical fund, the base for the management fee after the investment period (assuming no realizations) would be \$85. If the fund then sold investments with a cost basis of \$50, the management fee base would drop to \$35. In the two funds referenced above, the management fee base following the disposition would have been \$50 (representing \$100 in total contributions less the \$50 in returned capital). Investors in those funds would be paying a continuing management fee on amounts used to pay previous fees and expenses.

Because opportunity fund management fees are generally based on committed capital during the investment period, management fees can vary widely among funds (even among funds with identical management fee rates) when measured as a percentage of the capital that the manager actually invests. For example, a manager that uses higher leverage has to do more work to deploy the same amount of equity commitments. Accordingly, high leverage rates can make an investment-period management fee less expensive, at least relative to the amount of work done by the manager. In addition, many managers use commitment re-loads (which allow a fund to re-draw certain distributions) and capital recycling provisions (which allow a fund to reinvest proceeds from realizations) to increase the amount of capital that they are able to invest over the life of the fund. In many cases, these provisions allow the total amount of equity that is invested by a fund to exceed its total capital commitments, even though the fund is required to pay management fees, organizational costs and other fund-level expenses. The use of recycling and re-loads can also make the investment period management fee less expensive than it may appear.

Other variations, such as post-investment period fees that are based on net asset value as opposed to invested capital, can also have a significant effect on the amount paid by investors. Accordingly, it is important for investors to look beyond the management fee rate and determine the amount that they are actually expected to bear—both in absolute dollars and relative to the amount of work that the manager is expected to do on the fund's behalf.

### INVESTING IN A CHANGING MARKET

Opportunity funds can unquestionably be expensive. Carried interest provisions are designed to generate substantial compensation for successful opportunity fund managers, sometimes reaching into the hundreds of millions of dollars for a single fund. For obvious reasons, the carried interest can serve as a powerful tool to motivate managers and align their interests with investors. However, because of its potential size, it can also depress investor returns if the manager is permitted to share in the fund's profit too early. Taken together with investment management and other fees, as well as organizational expenses, broken deal expenses and other fund costs, carried interest can contribute to a significant gap between a fund's gross returns and the net returns actually realized by investors.

However, the total cost is not necessarily unreasonable. Opportunity fund strategies are generally labor intensive, both because opportunistic investments generally require more work to identify and oversee than core assets, and because the limited life span of an opportunity fund requires managers to continually re-execute their strategies. Because of high leverage and because of commitment re-loads and recycling, the

## OPPORTUNITY FUND FEE STRUCTURES IN A CHANGING MARKET

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base fees that managers receive for these efforts can be relatively low when considered in light of the amount of capital that they deploy. Although the total compensation can climb precipitously, that occurs only after the manager has delivered threshold returns for investors.

Of course, the real justification for high manager compensation (even if much of it is contingent) is their perceived ability to continue delivering high expected risk-adjusted returns. In this changing environment, it is more important than ever to select managers that have developed strategies and assembled teams that will allow them to do just that.

However, strong manager performance, by itself, is not enough. Investors must be diligent in evaluating terms and conditions of the funds that they invest in, as well as the use of operating partners and other manager practices, to ensure that the manager's success in executing its strategy will also result in a successful investment for fund participants.