Raising Your Commercial IQ

Creating & Profiting from Joint Ventures

September 2015

Neil Osborne M.B.A.
DL. (604) 988-5518
nosborne@investitsoftware.com
Investit Software Inc.
Toll free 877-878-1828
North Vancouver BC
Canada
investit@investitsoftware.com
www.investitsoftware.com

Table of Contents

Objectives

1. Provide an introduction to the nature of joint ventures
2. Show how to use joint ventures to structure deals and earn commissions and/or profits
3. Provide a universal framework for thinking about, analyzing and structuring joint ventures
4. Demonstrate joint venture creation and analysis using case studies
5. How to analyze complex investments such as syndications

Characteristics of Joint Ventures

One time project

Pooling of resources, sharing of risk

Money

Knowledge and expertise

Control over or ownership of a desirable property

Examples of Joint Ventures

Small group buys an apartment building

Land owner and a developer

Financial lender and a developer

Sometimes there are tenants who don't like paying rent and would prefer to own but don't have enough money to buy a building. Instead they form a joint venture with an investor to develop or buy an income property and do this through a joint venture arrangement.

Joint ventures between Investor/Tenant and an Investor and are quite common. There are a lot of opportunities to put these JV deals together.

From the investor's perspective there are a number of advantages. Let's assume that the Investor/Tenant will occupy 1/3 of the building. The advantages for the investor are:

1. Risk is reduced because 1/3 of the building is leased to a strong tenant who is motivated through ownership to stay in the space
2. Makes arranging financing easier
3. In the case of a new development the lender may have pre-leasing requirements. Because the Investor/Tenant will occupy 1/3 of the space it will be easier to arrange a construction loan and the long term financing
4. Less risk of the space becoming vacant. Re-leasing space is very costly. There is the lost rent which can be substantial and leasing and legal fees to be paid.
5. Needs less capital to investment in the building

From the Investor's perspective the key is to enter into a joint venture with an Investor/Tenant who is financially strong and has a successful business.

From an Investor/Tenant perspective they are able to invest in a building that they could not afford, share in the operating cash flow and hopefully long term capital appreciation.

There are many Investor/Tenant and Investor JV possibilities. The purchase of a single family home, office, industrial and retail tenant who would rather own than pay rent

Joint Venture Case Study. G & B Estate

The partner of an architectural, engineering and real estate company had been puzzled as to why a large, superbly located site which had been on the market for a long time, had not sold. The price seemed very attractive. A ‘For Sale” had been on the site for several years.

The site was zoned industrial with a large vacant timber manufacturing building.

The site had a magnificent view of downtown Vancouver and the mountains and was situated above the popular market and theatre arts area called Granville Island. Downtown Vancouver is minutes away.

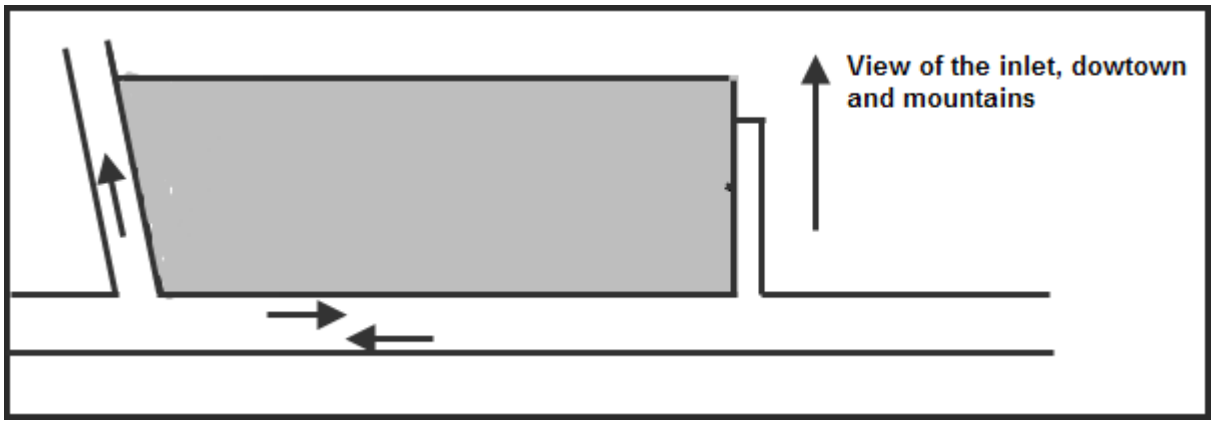
A title search was conducted to discover the owners which turned out to be an “Estate”. The firm met with the executors to find out more their objectives and why the property had not been sold.

For a developer to buy this site he needed to have the purchase subject to obtaining a re-zoning and a preliminary development permit, which could take 6 to 12 months or more to obtain.

Conditions in the Will prevented the executors of the estate from accepting an offer that had long subject clauses related to re-zoning approvals.

A preliminary development analysis was carried to determine the land value and the real estate firm proposed a joint venture with the Estate to obtain the preliminary development approval and sell the property. The real estate division of the firm would be given a listing for two years. The profit generated after deducting costs and the land value would be split 50/50

Asking Price for the land: $1,300,000 (This would be the price used in the joint venture)
The architects would not be paid their fees unless the property sold.
The estate would pay the architects out of pocket costs such as building a scale model, application fees etc.



Views: 25 years later. Spectacular view

Joint Venture result

Sale of the re-zoned property	$1,700,000
Less: Real estate fee	60,000
	1,640,000
To the estate $1,300,000 for the land	1,300,000
Architectural & engineering fees	65,000
Disbursements	20,000
Profit	255,000
Profit 50/50 split	$127,500

Legal forms of a joint venture

A joint venture is not a legal entity. It could be in the form of a partnership, corporation such as:

Individual – JV – Corporation
Corporation 1 – JV – Corporation 2
Partnership – JV – Individual
Architectural & Engineering firm – JV - Estate

The tax and legal issues are very important and your clients need to get expert advice in these areas before entering into a joint venture agreement.

The focus of this session is how to structure and analyze joint ventures from a financial perspective.

Promoting a joint venture

Care has to be taken in how you promote a joint venture to ensure you do not breach security and other related acts.

The general rules are:

The investment group is small. Example: Introducing a land owner to a developer

People in the group should know or indirectly know each other

Don't advertise or promote the joint venture in the newspaper

Joint venture partners should be active in decision making, vote, attend meetings and share in profit and losses.

A major test as to whether a venture is a security is;

- The degree of separation between ownership and control.
- If the promoter manages and controls the project, and the investors only decision is to invest, then it is likely a security

Role of the Realtor, Fees & Commissions

Potential roles of a realtor:

Create the idea or opportunity

Find and introduce compatible partners

Carry out the feasibility study

Negotiate the acquisition of the property

Assist in the structuring the financial aspects of the joint venture

Sell or lease the completed project

Potential fees and commissions

Introduction fee

Fee for negotiating the acquisition of the property

Fee for setting up the joint venture

Project management fee

Profit sharing

Fee for leasing or selling the property

The extent, to which you can charge fees, will depend on how much the joint venture partners value your contribution, knowledge, expertise and contacts etc.

Success comes from your ability to discover and structure unique and profitable investment opportunities.

Be very well prepared when you attend meetings. Know the answers to the typical “what if” questions. Follow these steps:

Be well prepared for meetings
Carry-out “what if” analysis
Set an agenda for the meeting
Anticipate & prepare for their questions
Follow up with a written summary of the meeting
& keep everyone informed on a regular basis

A framework for structuring joint ventures

The equity contributions don't necessarily determine how cash flow during operations and when the property is sold and how the sales proceeds are distributed.

There are many creative ways to structure a joint ventures ranging from simple to complex.

The simplest is that the operating cash flows and the distribution of the sales proceeds are based on the equity contribution. As an example, if Partner A puts 40% of the equity she gets 40% of the operating cash flow (including contributing to her share of the losses), and 40% of the sales proceeds after returning the equity contributions.

Following is a useful framework for developing the financial terms of joint venture

1. Now. **On formation**

   Equity contributions by each partner at the start and in the future

2. During. **Sharing of operating cash flows, contributions etc.**

   Positive cash flows, operating losses and capital cost overruns

   There are many ways to structure the sharing of the operating cash flow.

   Some examples:
   Partner A puts up 40% but shares in 50% of the operating cash flow and is not responsible for negative cash flow which is covered by the other partners

   Partner A puts up 40% of the equity. Once the funds from operations reaches $100,000 Partner A receives the first $7,000 of monthly operating cash flow with the remainder being distributed to the other partners

   End**. On dissolution**
   What happens when the property is sold?

   How are the sales proceeds or the residual distributed after:
   - Paying off the mortgage , real estate fees and closing costs
   - Returning the equity contributions of each partner **(This is very important)**

   Some examples:
   Partner A put up 40% of the equity but shares in 50% of the sales proceeds
   Partner A puts up 40% of the equity and receives the first $100,000 of the sales proceeds. Partner B get the next $150,000 and then they split the remainder of the sales proceeds 50/50

3. Roles and responsibilities
   Who does what? How will they be remunerated? When will they be paid?

   A simple and fair approach to compensation is the **"At market approach"**
   As an example, if one of the investors does the book keeping, the investor gets paid the market rate for bookkeeping services.

Approach to structuring the deal

First start by checking whether the investment makes economic sense. If the opportunity doesn't make send as an investment it won't work as a joint venture. This means carrying out real estate investment analysis to establish the financial returns and whether they returns are sufficient given the investment risk.

In the office building example which will use later as a JV case study, the investment works because the Internal Rate of Return (IRR) is 16.02% which is greater than the desired return of 13% before tax.

This office building investment works as an investment and will work as a joint venture.

Net Cash Flow (Before Tax)

Year	Investment	Financing: Borrow	Financing: Paid Back	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (3,200,000)	$ 2,400,000	-	$ 23,983	-	$ (776,017)
Year 2 Jan-Year 2 Dec	-	-	-	27,823	-	27,823
Year 3 Jan-Year 3 Dec	-	-	-	31,663	-	31,663
Year 4 Jan-Year 4 Dec	-	-	-	35,663	-	35,663
Year 5 Jan-Year 5 Dec	-	-	(2,090,510)	39,823	3,561,290	1,510,603
					Total	$ 829,735

Financial Returns (Before Tax) with Financing
Internal Rate of Return (IRR) 16.02%
Net Present Value (NPV) at 13.00% $ 106,725

In this example the Internal Rate of Return (IRR) is 4.29% and the minimum desired return is 13.00% before tax. This is not a viable investment from a financial standpoint and won't work as a joint venture.

In fact the investor's' would do better being second mortgage lenders where they might earn 7.00% or more.

For this investment to work the purchase price needs to be dropped by $1,174,516 in order to achieve a desired return (IRR) of 13.00% before tax.

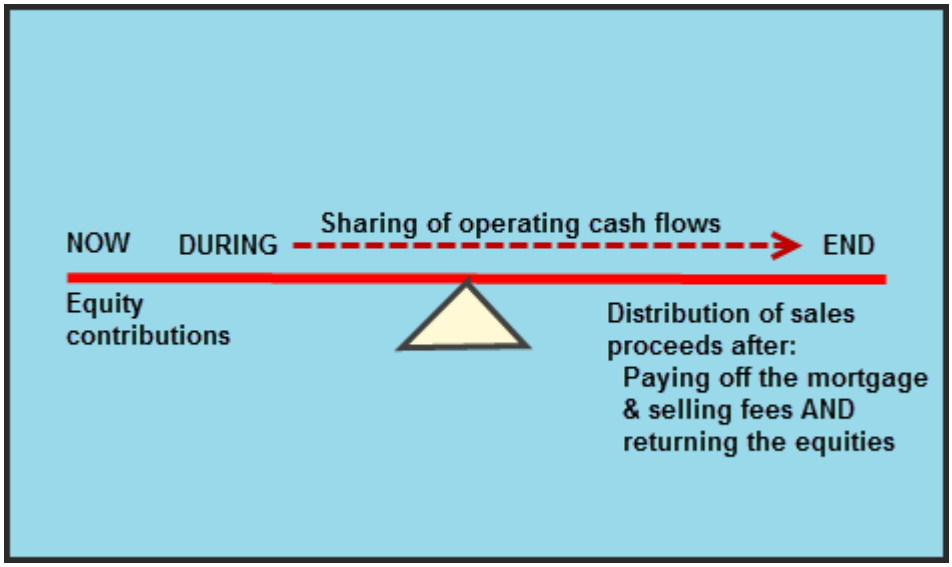
Net Cash Flow (Before Tax)

Year	Investment	Financing: Borrow	Financing: Paid Back	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (6,000,000)	$ 2,400,000	-	$ 23,983	-	$ (3,576,017)
Year 2 Jan-Year 2 Dec	-	-	-	27,823	-	27,823
Year 3 Jan-Year 3 Dec	-	-	-	31,663	-	31,663
Year 4 Jan-Year 4 Dec	-	-	-	35,663	-	35,663
Year 5 Jan-Year 5 Dec	-	-	(2,090,510)	39,823	6,359,505	4,308,818
					Total	$ 827,950

Financial Returns (Before Tax) with Financing
Internal Rate of Return (IRR) 4.29%
Net Present Value (NPV) at 13.00% ($ 1,174,516)

Note:
To learn more about investment analysis please see the video and workshop manual "Real Estate Investment and Lease Analysis"

Structuring the joint venture in involves deciding how to balance the equity contributions, the sharing of operating cash flows and how the sales proceeds are distributed after paying off the mortgages, real estate fees and closing costs and returning the equity contributions in a way that provides each venture and acceptable return given their risk.



Developing the financial structure of the JV this involves a trial and error process.

Start by picking a financial structure you think might work and;

1. Develop the net cash flow for each investor and calculate the financial return using the Internal Rate of Return (IRR)

2. Compare the returns for each investor.

   Are they equitable given the degree of risk, which may vary for each partner?

3. If not equitable, adjust one or several of the following;

   Equity contributions. Now and in the future

   Sharing of cash flows (positive and negative)

   Distribution of sales proceeds

   Roles, responsibilities and remuneration

4. Compare the financial returns for each co-venturer on the basis of win/win or no deal

Remember that;

Each investor will compare their return against other investment opportunities, including doing nothing, by taking into account the risks, rewards and effort involved.

Try to think like they will think.

Care has to be taken how the joint venture profits are calculated.

Example. One of the co-venturers is a contractor. In this case the construction costs have to be clearly specified and controlled because it is very easy for an unscrupulous contractor to manipulate the constructions costs, increase his profits and reduce the joint venture profits.

Suggestions for controlling the construction costs:

1) Provide the contractor JV partner with very detailed drawings and specifications
2) Partner with an experienced contractor with an excellent reputation
3) Use a fixed price contract Avoid a cost plus contract
4) Clearly specify the contractors mark-up on labor and materials
5) Agree on management and overhead fees
6) Specify the contractor's mark-up on the cost of change orders

Change orders and extras
Changes and extra costs during construction occur for a variety of reasons, such as:

The cost of correcting a design mistake
Upgrading of materials, finishes and fixtures
E.g. Carpets, appliances, light fixtures etc.

The following steps can be taken to control the cost of change orders and extras:

1) Have very detailed drawings and specifications
2) Specify how the contractor's profit on the change order will be calculated
3) Set up a change order approval system that involves the other co-venturers

Analyzing Mutually Exclusive Investments

Mutually exclusive investments are investments where the investor has several options that are mutually exclusive. They can choose one of the options but not both. Some examples of mutually exclusive investments are:

Buy or Lease?

Hold or Sell?

Personal choice example. I can drive to work or catch a bus but I can't do both

Using the Buy versus Lease as an example, mutually exclusive investments are analyzed as follows:

Develop the "Net cash flow" for the "Buy" option

Develop the "Net cash flow" for the "Lease" Option

Calculate "Net Cash Flow Buy – Net Cash Flow Lease"

This is called the "Differential" or 'Incremental Cash Flow" analysis and is a very important concept which has a lot of applications in joint venture analysis and will be used in the first joint venture case study..

Analyzing Buying versus Renting a home. Case Study

Purchase Price: $700,000
First Mortgage: $550,000, Interest Rate 4.50%, 25 year amortization
Property Taxes: $4,500 per year increasing at 4.50% compounding per year
Insurance: $600 per year increasing at 3.00% per year compounding
Maintenance $150 per month increasing at 3.00% compounding per year
Utilities: Ignored because the utility costs apply to both buying or renting
Appreciation: 6.00% per year
Analysis Period: 5 years

Buyer's Discount Rate (Desired Return): 10%

Renting
Rent: $2,200 per month increasing at 3.50% per year compounding

What is the return on the investment?

What is the financial return if we treat the purchase of the home as an investment rather than a "Mutually Exclusive Investment" i.e., ignoring the savings in renting?

Answer: Internal Rate of Return (IRR): 2.88%

Net Cash Flow (Before Tax)
Buying a home
Apparent Return on Investment

Year	Investment	Financing: Borrow	Financing: Paid Back	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (700,000)	$ 550,000	-	$ (43,585)	-	$ (193,585)
Year 2 Jan-Year 2 Dec	-	-	-	(43,866)	-	(43,866)
Year 3 Jan-Year 3 Dec	-	-	-	(44,144)	-	(44,144)
Year 4 Jan-Year 4 Dec	-	-	-	(44,444)	-	(44,444)
Year 5 Jan-Year 5 Dec	-	-	(483,218)	(44,754)	889,920	361,948
					Total	$ 35,909

Financial Returns (Before Tax) with Financing
Internal Rate of Return (IRR) 2.88%
Net Present Value (NPV) at 10.00% ($ 64,656)
Modified Internal Rate of Return (MIRR) 3.66%
Short Term Financing Rate (Before Tax) 6.000%
Short Term Reinvestment Rate (Before Tax) 1.500%

To get a 10% IRR the price needs to be dropped by $64,656

Buy versus Rent Analysis using the differential cash flow analysis approach

Net Cash Flow. Buy v Lease (Before Tax)
Buy vs. Renting a Home

November 01, 2012
Investor Pro
Video Buy vs. Renting a home

Year	BUY: Investment	BUY: Financing Borrow	BUY: Financing Paid Back	BUY: Operating Cash Flow (Before Tax)	BUY: Sale Proceeds (Before Tax)	BUY: Net Cash Flow (Before Tax)	LEASE: Leasing Expenses (Before Tax)	BUY v LEASE: Cash Flow Difference (Before Tax)
Year 1 Jan-Year 1 Dec	$ (700,000)	$ 550,000	-	$ (43,585)	-	$ (193,585)	$ (26,400)	$ (167,185)
Year 2 Jan-Year 2 Dec	-	-	-	(43,866)	-	(43,866)	(27,324)	(16,542)
Year 3 Jan-Year 3 Dec	-	-	-	(44,144)	-	(44,144)	(28,284)	(15,860)
Year 4 Jan-Year 4 Dec	-	-	-	(44,444)	-	(44,444)	(29,268)	(15,176)
Year 5 Jan-Year 5 Dec	-	-	(483,218)	(44,754)	889,920	361,948	(30,300)	392,248
					Total	$ 35,909	$ (141,576)	$ 177,485
					Net Present Value (NPV) at 10.00%	$ (64,656)	$ (106,636)	$ 41,980

BUY v LEASE Financial Returns (Before Tax)
Internal Rate of Return (IRR) 14.80%
Net Present Value (NPV) at 10.00% $ 41,980
Modified Internal Rate of Return (MIRR) 13.72%
Short Term Financing Rate (Before Tax) 6.000%
Short Term Reinvestment Rate (Before Tax) 1.500%

If we paid $41,980 more for the house the return (IRR) for buying versus renting would be 10%

Conclusion.
If the Net Present Value (NPV) is positive consider buying.
If the Net Present Value (NPV) is negative consider Leasing.

Consider Buying if the Total Purchase Price is approximately $ 741,980 or less.

Results Summary

Approach	Internal Rate of Return (IRR)	Result
Investment Analysis	**2.88%**	**Incorrect**
Buy versus Rent Analysis (Differential cash flow analysis)	**14.80%**	**Correct**

Joint Venture Case Study No. 1

A young couple has saved $40,000 for a down payment on a home. They and have found an ideal home in an expensive neighborhood, where a $100,000 down payment is required. They would really like to buy the home now, because the feel real estate values will increase significantly over the next few years.

The husband is a doctor and the wife a CPA. Their combined earnings are high and they have an excellent credit rating. An investor you know has expressed an interest in forming a joint venture with them to purchase the home.

Develop the general terms of the joint venture so that it is a good deal for both parties using the information below and outline the financial advantages and disadvantages for each investor.

Analysis or holding period	Five years
Purchase Price	$500,000
First Mortgage	$400,000, 4.00%, 25 year amortization
Loan to Value Ratio	80%
Monthly payment	$2,111 or $25,332 per year
Balance at end of five years	$348,419
Equity	$100,000
Property taxes	$3,000 per year or $250 per month
Insurance	$750 per year or $63 per month
Maintenance	$1,500 per year or $125 per month
Expense escalations	3% per year compounding

The investor will contribute $60,000 and the young couple $40,000. For the exercise assume that the first mortgage cannot be higher than $400,000

Capital Appreciation: It is anticipated it will increase at 3% per year compounded over five years and will be worth $579,637 when it is sold in five years' time.

Anticipated holding period. Five years
Real estate and legal costs for selling the home will be 5% of the sale price.

The young couple could rent a similar home for $2,200 per month or $26,400 per year. Rents are expected to increase at 3% per year compounded.

The framework for analyzing joint ventures is;

Adjust:

- Equity contributions
- The sharing of operating cash flows (positive and negative)
- The distribution of sales proceeds
- Roles, responsibilities and compensation

on the basis of win/win or no deal.

Remember that each investor will compare this opportunity against other opportunities (including doing nothing) by taking into account the rewards and risks.

One possible arrangement

1. **On Acquisition**. **Capital contributions**

Young couple		$40,000	40%
Investor		60,000	60%
	Total	$100,000	100%

2. On Disposition. How will they share the proceeds from sales?

Young couple		50%
Investor		50%
	Total	100 %

Calculation of sales proceeds

Sale price	$579,637
Less:	
Repayment of the mortgage	348,419
Real estate and legal fees	28,981 (5%)
Proceeds from sale	$202,237

Distributions of sales proceeds

	Young Couple	Investor	Total
Return of Equity	$40,000 (40%)	$60,000 (60%)	$100,000
Share of Profit[(1)]	51,119 (50%)	51,119 (50%	102,238
Total	$ 91,119	$111,119	$202,238

Note [(1)] Includes principal paid on the mortgage as well as the profit

During ownership

How will the monthly payment of principal, interest, taxes, insurance and maintenance be shared?

	Monthly cost	Young couple	Investor
Mortgage	$2,111	$ 2,111	0
Property taxes	250	250	0
Insurance	63	63	0
Maintenance	125	125	0
Total	$2,549	$2,549	0
Year	$30,588	$30,588	0

Note: Property taxes, insurance and maintenance increase at 3% per year compounding

Young couple. Costs associated with owning

Year	Mortgage Payment	Costs TIM's	Total
1	$25,332	$5,256	$30,588
2	25,332	5,414	30,746
3	25,332	5,576	30,908
4	25,332	5,743	31,075
5	25,332	5,916	31,248

Young couple. Net Cash Flow "Owning versus Renting"

To determine the Return (IRR) for the young couple, we have to calculate the differential cash flow of "owning" versus "Renting"

This is an example of "Mutually Exclusive" investment analysis. The young couple can "own" or "rent" but they can't do both.

Mutually exclusive investment is analyzed using differential cash flow analysis.

We develop the Net Cash Flow of Owning and the Net Cash Flow for rent.

The differential cash flow of owning versus renting is:

Net Cash Flow. Owning – Net Cash Flow. Renting

They differential calculations and results are shown in this table.

	Net Cash Flow. Owning			Net Cash Flow. Renting	Owning vs. Renting
Year	Equity	Annual Payments	Cash Flow from Sale	Net Cash Flow	Rent	Differential Cash Flow
0	-40,000			-40,000		-40,000
1		-30,588		-30,588	26,400	-4,188
2		-30,746		-30,746	27,192	-3,554
3		-30,908		-30,908	28,008	-2,900
4		-31,075		-31,075	28,848	-2,227
5		-31,248	91,119	59,871	29,713	89,584

Internal Rate of Return (IRR) 12.38%

The incorrect calculation. Ignoring the savings in rent

	Net Cash Flow. Owning			
Year	Equity	Annual Payments	Cash Flow from Sale	Net Cash Flow
0	-40,000			-40,000
1		-30,588		-30,588
2		-30,746		-30,746
3		-30,908		-30,908
4		-31,075		-31,075
5		-31,248	91,119	59,871

In this example the analysis does not take into account the savings in rent.

The Internal Rate of Return (IRR) is <31%> which is clearly wrong.

Using differential cash flow analysis which recognizes the saving in rent, the Internal Rate of Return (IRR) is 12.38%

Investor. Joint venture. Net Cash flow and Return on Investment IRR)

Year	Equity	Annual Contribution	Cash Flow from Sale	Net Cash Flow
0	-60,000			-60,000
1		0		
2		0		
3		0		
4		0		
5		0	111,119	111,119
		Internal Rate of Return (IRR)		13.12%

The return to the investor is 13.12%

Investor. Buying & renting the home

If the investor by a home and rents it out, there is a possibility of a vacancy loss which is estimated to be 6%. The vacancy loss was calculated using the following assumptions::

With single rental units such as a house of condominium the unit is either rented or vacant which means that the vacancy loss is probably higher than a rental apartment building.

It takes two months the rent the house
The house is vacant twice over the 5 year ownership period

Vacancy Loss = (2 months/12) x 2 times / 5 years = 6.67%

Vacancy Loss used was 6%

The investor could purchase a home, rent it out and then sell it in five years . If the investor did this the Return on Investment (IRR) is 11.54*% which is less than the joint venture return of 13.20%

Investor. Net Cash Flow. Buying and renting the home as an investment

Year	Equity	Rental Income	Vacancy Loss 6%	Mortgage Payments	Operating Expenses	Cash Flow Sale	Net Cash Flow
0	-100,000						-100,000
1		26,400	-1,584	-25,332	-5256		-5,772
2		27,192	-1,632	-25,332	-5414		-5,186
3		28,008	-1,680	-25,332	-5576		-4,580
4		28,848	-1,731	-25,332	-5743		-3,958
5		29,713	-1,783	-25,332	-5916	202,237	198,919
						Internal Rate of Return (IRR)	11.54%

Financial Summary

	Internal Rate of Return IRR)
Young couple. Joint venture Own versus Rent	**12.38%**
Investor. Joint venture	**13.12%**
Investor. Buys and rents	**11.54%**

Advantages of the joint venture

Young Couple	Investor
A return of 12.38% compared to renting	A return of 13.12% compared to 11.54% if he bought the home as an investment which is an increase of 14% in his return on investment
Enter the real estate market sooner	Passive investment unless the young couple default
Live in a neighborhood they can't currently afford	No negative cash flows to feed
	No vacancy loss and no property management fees

Developing the financial structure of joint ventures often requires several attempts in order to structure the venture so that it is financially fair for each party, given the degree of risk they are taking.

Remember that each investor will compare the anticipated returns and the risks with other investment opportunities including doing nothing.

Young couple. Buyout in five years

If the young couple wished to buy out the investor in five years' time, how much money would they need? They would need to inject $10,310 additional cash to buy the investor out.

Their monthly mortgage payment would go from $2,111 per month to $2,447 per month if they refinanced based on a 80% Loan to Value Ratio, 4.00% interest and 25 year amortization.

Market value in 5 years time	$579,637	
Financing at a 80% Loan to Value Ratio	463,709	4.00%, 25 year amortization
Pay off the OSB existing mortgage	348,410	
Proceeds from refinancing	115,299	
Pay Investor's profit ($111,119 + 14,490)[(1)]	125,609	
Young couple. Cash from re-financing	-10,310	
Mortgage payment will increase from $2,111 per month to $2,447 per month		

Note[(1).] Half the real estate fees of $28,981 i.e., $14,490 have been added to calculate the proceeds to the investor when to property is re-financed.

What if analysis

The above analysis was based on splitting the sales proceeds 50/50 after first paying off the mortgage and related selling expenses and then returning the initial equities.

What would the financial returns look like if the sales proceeds were split based on the equity contributions of 40% for the Young Couple and 60% for the Investor?

Distributions of sales proceeds

Distribution of the sales proceeds

	Young Couple	Investor	Total
Return of Equity	$40,000 (40%)	$60,000 (60%)	$100,000
Share of Profit[1]	40,895 (40%)	61,343 (60%)	102,238
Total	$80,895	121,343	$202,238

Note[1] Includes principal paid on the mortgage as well as the profit

Cash Flow. Young Couple

Year	Equity	Renting	Owning	Cash Flow Difference	Cash Flow from Sale	Net Cash Flow
0	-40,000					-40,000
1		26,400	30,588	-4,188		-4,188
2		27,192	30,746	-3,554		-3,554
3		28,008	30,908	-2,900		-2,900
4		28,848	31,075	-2,227		-2,227
5		29,713	31,248	-1,534	80,895	$79,361
				Internal Rate of Return (IRR)		9.44%

Investor. Cash Flow

Investor. Cash Flow

Year	Equity	Annual contributions	Cash Flow from Sale	Net Cash Flow
0	<60,000>			<60,000>
1		0		
2		0		
3		0		
4		0		
5		0	121,343	121,343

Summary and Conclusions

If the sales proceeds after paying off the mortgage, real estate fees and returning the original equity to each investor are changed from 50/50 to 40% for the Young Couple and 60% for the Investor the financial returns change as follows:

	Initial Equity	Sharing of sales proceeds	Internal Rate of Return (IRR)	Sharing of sale proceeds	Internal Rate of Return (IRR)
Young Couple	40%	50%	12.38%	40%	9.44%
Investor	60%	50%	13.12%	60%	15.14%

Note: Sales proceeds is the amount to be spilt between the Young Couple and the Investor after paying off the mortgage and releated selling costs and returning the orgial equity of $40,000 to the Young Couple and $60,000 to the Investor

The return to the Young Couple drops from 12.38% to 9.44%. The Investor's return increases to 15.14% from 13.12%

Calculation of the Sales proceeds

Sale Price
Less: Mortgage balance
Selling expenses
Return the equities
Proceeds available for distribution

Joint Venture rules

1. If you increase the return to one of the parties you automatically decrease the return to the other parties

   To give more to one party you have to take from the others

2. If it not economically viable as an investment it won't work as a joint venture

Joint Venture Agreement. What if clauses?

"What if" specifies what happens if certain events occurs such as:

What about major expenditures?

Example. Replacing the roof or the hot water tank.

How do you define major expenditures?
How will these costs be shared?

Definition of a major expenditure

_____

Sharing of costs

_____

Notification and approval process. Major expenditures.

The joint venture agreement needs to spell out the notification and approval process and who is responsible for major expenditures.

As an example:

Young couple
Has to get a minimum of two proposals
Has to notify the investor of the cost and receive his approval
Organize the work and ensure it is completed properly and deal with warranties

Disagreements
The joint venture agreement needs to define a system for handling disagreements that can't be resolved by the co-venturers such as disagreeing over the need for a major expenditure.

There are many ways to set up a system for handling unresolved disagreements which depend in part on the complexity of the joint venture and number of co-venturers and is best left to the lawyer the provide the appropriate clauses which need to be tailored to the specific joint venture.

A common approach is to use an arbitrator to negotiate unresolved disagreements.

Default Arrangements

What happens if one party can't come up the money for;

- Operating losses
- Major expenditures

Default clauses are often complex and are best left for the lawyers to develop. Default clauses depend on the specific joint venture and the financial arrangements between the co-venturers.

Default clause. Example:

Interest Rate
One party(s) contributes the defaulting amount on behalf of the defaulting partner they receive interest at 18% and the defaulting party pays 18% interest

The interest rate is set high to discourage a default

Time
After six month if the default amount plus accrued interest is not paid there is a share adjustment based on the defaulting amount plus unpaid interest

Share adjustment
The joint venture agreement needs to specify how the share adjustment will be made and there are many ways to do to make the share adjustment such as:

Renting
Should the young couple be able to rent out the home? There are two options:

1. They are not allowed. This option is probably too harsh and unfair
2. They are allowed to rent the home but not profit from renting the home at the investors expense

If the rental income is higher than the mortgage payment, property taxes, insurance and maintenance paid by the young couple then the profit will be spilt 50/50 between the young couple and the investor.

Roles, responsibilities and compensation

JV agreement needs to define who will do what and how they are compensated is often very touchy area. One way to avoid disagreements over compensation is the use the “At Market Approach”

At market concept
The co-venturers are paid the market rate for the activities they perform. As an example, if one of the co-venturers is doing the bookkeeping the compensation would be based on the going rate for bookkeepers. If one of the co-venturers is a commercial realtor and is responsible for negotiating leases, the compensation would be based on the typical leasing fees that are paid in the area.

In this joint venture the investor is passive and the young couple are responsible for the looking after the home in the same way they would if they owned the home one hundred percent.

	Young couple	**Investor**
Financial	_____	_____
	_____	_____
Non financial	_____	_____
	_____	_____

Other investment options

Young Couple	**Investor**
Buy a smaller house	Buy a house and rent it out
Buy in a less expensive neighborhood	Investit in the stock market
Rent and invest their down payment in the stock market	Become a second mortgage lender
_____	_____
_____	_____

Important Note

For the joint venture to be financially attractive to the investor the return should be higher than the second mortgage rate for the property.

Buy/Sell arrangements

If one party wants to buy out the other party, or if one party dies, how will their interest be valued?

Shot Gun Clause

The objective of a shot gun clause is to enable one partner to buy out the other at a fair market value and work like this;

If Partner A offers to buy out Partner B for $750,000, Partner B can;

1. Accept the $750,000 and sell his interest to Partner A
2. Say no thanks and buy out Partner B for $750,000

Hopefully this ensures that the partner making the offer makes a fair, rather than a low ball offer.

A “Shot Gun Clause” may not in the best interest of one partner if;

1. One partner is financially strong and the other has limited financial capabilities
2. Only one partner is capable of running the business. The other partner is not capable of running the business or has no interest in running the business. The operating partner is in a stronger position regarding the shot gun clause

Formula approach

A common approach used to establish the buyout value used in joint ventures and shareholder agreements is to use a formula for establishing the value.

There are many ways to do this and the formulae used to establish the value depends on the nature of the joint venture and often is established through negotiations between the partners.

Some simple examples for an income property.

Buyout Value = Average Net Operating Income for past 3 years/7% Cap Rate
If the average Net Operating Income is $270,000

$$\text{Value} = \frac{\text{Average Net Operating Income past 3 year}}{\text{7\% Cap Rate}}$$

$$= \frac{\$270{,}000}{\text{7\% Cap Rate}} = \$3{,}857{,}147$$

Using a weighted average
Another approach is to use d is a weighted average which can recognize that that more recent better reflect the financial performance of the property and should have more influence on the value.

Example
Value = Weighted average of the Net Operating Income over the past three financial years and a 7% Cap rate using the following weights:

Year	Net Operating Income	Weight	Weighted Value
2013	$285,000	60%	$171,000
2012	$275,000	30%	$82,500
2011	$250,000	10%	25,0000
	Average $270,000	**100%**	**Weighted Average $278,500**

Value based on the Average Net Operating Income = $270,000/7% Cap Rate = $3,857,143

Value based on the Weighted Net Operating Income = $278,500/7% Cap Rate = $3,978,514

Using Cash Flows to establish the value
Business value is often calculated using "Earnings Before Interest, Taxes and Amortization (EBITDA) times a multiplier.

Business Example
EBITDA = $360,000
Multiplier: 2.5
Buy-out Value = $360,000 x 2.5 = $900,000

EBITDA and the Net Operating Income are the same.

EBITDA = Net Operating Income (Excludes interest, principal. taxes and depreciation)

Another method for establishing value is the net Income Multiplier which is the inverse of the Cap Rate

Net Income Multiplier = 1/Cap Rate
= 1/7% = 14.29

Using the EBITDA and a multiplier is the same as using the Net Income Multiplier or the Cap Rate to establish the buy-out value.

EBITDA is used by accountants and business brokers and the Net Income Multiplier or Cap Rate is used by investors and real estate brokers to establish value. It's the same approach using different terminology.

Real estate example using the Cash Flow before Tax
Value = Cash Flow before tax x 42
Cash Flow before Tax = $86,212
Multiplier: 42
Buyout Value = $86,000 x 42 = $3,612,904

	Year 1
CASH FLOW BEFORE TAX	
Potential Gross Income	**499,200**
Less: Vacancy & Credit Loss Allow.	14,256
Effective Gross Income	**484,944**
Operating Expenses	221,374
Net Operating Income	**263,570**
Less: Principal Payments	28,318
Interest payments	149,040
CASH FLOW BEFORE TAX	**86,212**

This might be a questionable approach. If the financing was changed by increasing or decreasing the mortgage or the amortization period the cash flow and buyout value would change but the income being generated by the property hasn't changed.

Fortunately determining the value of an income property is much easier than valuing a business because we can use a qualified appraiser to establish the value but there may be specific cases where the formula approach can be used such as valuing a development

Buy-out Value. Land owner and the developer

A common joint venture is between and land owner and a developer where the land owner would like to participate in the development profit but doesn't have the skills or the capital to go through the development process but there are development risk involved for the land owner in being involved in a development.

For the developer to proceed with the development they will have to secure the construction loan or draw mortgage on the land.

The risk for the land owner is that if the development runs into financial difficulty the developer may default on the interest payment or the repayment of the principal, the development end up in a court action which is costly and can take years to resolve.

The end result is that the landowner doesn't get a share of the development profit and loses a lot of money.

The safest approach is that the developer buys out the land owner once the development is approved by the city and prior to the start of construction.

This means they buy-out value has to be established when the development has been approved by the city.

There are several ways to do this.

Appraisal approach

1) At the start the land owner and the developer agree on the value of the raw land
2) An appraisal is obtained once the development is approved
3) The land owner receives the raw land value plus "X%" percent of the increase in value

Example
Raw land value $1,200,000
Appraised value on the issuance of the building permit $1,800,000
Land owner receives 30% of the increase in value but not less than $1,200,000
The costs of getting the building permit are paid by the developer
The developer cannot register any claims of the property

Increase in value: $1,800,000 – 1,200,000 = $600,000

Profit for the landowner: 30% x $600,000 = $180,000

Land owner receives $1,200,000 + 180,000 = $1,380,000

Using the formula approach

One of the uncertainties facing the developer doesn't know what the city will approve.

Where we have an "Unknown" which will become "Known" at some time in the future, we can use a formula to establish the final value.

Example
Base price: $1,200,000

For very unit approved by the city over 25 units the land owner receives an extra $20,000 per unit.

If 35 units are approved the land owner receives:

$1,200,000 + $20,000 x (35– 25) = $1,200,000 + 200,000 = $1,400,000

Insured Buy-outs

If one of the parties dies or is disabled a number of issues arise that should be dealt with in the buy-out agreement

1. Selling an interest in small ventures can be very difficult making it hard for the estate to dispose of their interest

2. The most logical buyers are the remaining partners or the organization but knowing that the estate can't sell the interest may offer a very low ball the buy-out price

3. The remaining partners may not want to be involved with members of the estate which could prove to be troublesome

4. If the estate does sell the interest the remaining partners may be stuck with a "outsider"

5. Funding the buy-out is a concern as the joint venture may not have the cash to fund the buy-out

One solution is an insured buy-sell agreement where the other partners or the entity take out insurance that funds the buy-out upon death.

This is a complex area and involves tax considerations. There are life insurance companies, financial institutions like banks and insurance agents that specialize in insured buy-out agreements and policies

Funding the buy-out

Insured buy-outs provide the funding for buying out the deceased or disabled partner's interest.

In the absence of an insured buy-out a **"Timed buy-out"** may be used which involves

1. A down payment

2. A note providing for payment of the remaining balance over a specified time period, the interest rate and payment frequency

3. The note may or may not be secured by assets or guaranteed by the entity or the partners

This mechanism allows for immediate purchase of the interest without putting up substantial upfront cash and organizations financial resources and is hopefully repaid from earnings.

The importance of legal and tax advice

From a legal perspective there are many ways to structure a joint venture. The joint venture is not itself is not legal entity.

It could be in the form of a partnership, corporation or as an individual. There are many possibilities.

Some examples are:

An “Individual” forms a joint venture with a “Corporation”

A “Corporation” forms a joint venture with another “Corporation”

An “Individual” forms a joint venture with another “Individual”

The tax and legal issues are very important. The legal form of the investment in the joint venture will affect taxes, busines risk and liabilities.

Each co-venturer should seek independent legal and tax advice and should do this before entering in the joint venture.

Once a joint venture has been set up it can be very difficult and costly to change the legal structure because the change may generate tax consequences.

As an example, the co-venturer decided to enter into the joint venture as an “Individual” and later found out from his accountant that the best vehicle was a corporation.

If the investment has gone up in value since the formation of the joint venture the “individual” may have to pay a capital gains tax when transferring the interest to the “corporation” as well as the associated accounting and legal cost

Always seek legal and accounting advice before entering into a joint venture. Failing to do so may be very costly later.

Joint Venture Case Study No. 2 Commercial Building

In the above example we used the purchase of a home to illustrate a joint venture arrangement. That example was chosen because it's easy to understand.

Let's look at a commercial JV case study.

The following is essentially the same approach applied to the purchase of a small office building which will be occupied by one of the joint venture partner. The details of the joint venture are:

The owner of a large, successful accounting firm that is currently renting has $300,000 to invest in an office building .and has found an ideal 16,000 Sq. Ft office building for $3,200,000. They can arrange a mortgage of $2,400,000 (75%) which requires equity of $800,000 (25%)

You know an investor who would be interested in being a joint venture partner and would put up the remaining equity of $500,000.

The Accounting firm wants to pay the operating expenses and the mortgage rather than rent.

Develop the general terms of the joint venture so that it is a good deal for both parties using the information below..

Purchase Price	$3,200,000
First Mortgage	$2,400,000, 4.00%, 25 year amortization
Loan to Value Ratio	75%
Monthly payment	$12,668 or $152,017 per year
Balance at end of five years	$2,090,510
Equity	$800,000
Operating expenses (TIM's)	$7.00 per Sq. Ft per Yr. increasing at 3.00% per year

The investor will contribute equity of $500,000 and the Accounting Firm $300,000.

Capital Appreciation: It is anticipated it will increase at 3% per year compounded over five years and will be worth $3,709,677 when the building is sold in five years' time.

Anticipated holding period is five years. At this point the investor would like to be bought out.

Real estate and legal costs for selling the building will be 4% of the sale price.

The Accounting Firm currently pays a rent of $18.00 (NNN) per Sq. Ft per Yr. which is projected to increase at 2.50% per year compounding and under the triple net arrangements pays $7.00 per Sq. Ft per year which is estimated to increase at 3.00% per year compounding

Questions to answer

1. Does it work as an investment?
   If it doesn't work as a an investment it won't work as a joint venture

2. What's the return from a Buy vs. Lease perspective?

3. What the best financial structure that is fair to both parties?

4. What if the JV is treated as an investment where:
   Accounting Firm pays market rent instead of the operating costs and the mortgage payments and they share the cash flows based on their equity contributions which are: .

   Accounting Firm: 38%,
   Investor: 62%

5. How much cash does the accounting firm need to buy out the investor in 5 years?

Does it work as an investment?

It is wise to check the investment to see if it works. If it doesn't work as an investment, it won`t work as a joint venture. The minimum desired return on investment is 13.00% (IRR) before tax

The Internal Rate of Return (IRR) is 16.02% before tax which is a respectable return for this type of building and exceeds the minimum return on investment (IRR) of 13.00%.

Net Cash Flow (Before Tax)

JV Acctountant

Investor Pro as Investment

Year	Investment	Financing: Borrow	Financing: Paid Back	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (3,200,000)	$ 2,400,000	-	$ 23,983	-	$ (776,017)
Year 2 Jan-Year 2 Dec	-	-	-	27,823	-	27,823
Year 3 Jan-Year 3 Dec	-	-	-	31,663	-	31,663
Year 4 Jan-Year 4 Dec	-	-	-	35,663	-	35,663
Year 5 Jan-Year 5 Dec	-	-	(2,090,510)	39,823	3,561,290	1,510,603
					Total	$ 829,735

Financial Returns (Before Tax) with Financing	
Internal Rate of Return (IRR)	16.02%
Net Present Value (NPV) at 13.00%	$ 106,725
Modified Internal Rate of Return (MIRR)	15.32%
Short Term Financing Rate (Before Tax)	6.000%
Short Term Reinvestment Rate (Before Tax)	0.750%

Joint Venture arrangement.

Since the acquisition works as an investment we can now explore how we can set up the joint venture which is a trial and error process. We try different financial arrangements until we find and arrangement that works for both the accounting firm as the investor/tenant and the investor.

1. **Now.**
   What are the equity contributions?

Accounting Firm	$300,000	38%
Investor	500,000	62%
Total	$800,000	100%

2. **During**
   Who will pay what?

   The accounting firm has offered to pay the operating expenses (TIM's) and the mortgage payments in lieu of paying the base rent and the additional rent for taxes, insurance and maintenance.

3. **End**
   How will they share the proceeds from the sale after paying:

   a) the outstanding balance of the mortgage
   b) real estate commission

   And returning the equity contributions which are:

Accounting Firm	$300,000	38%
Investor	500,000	62%
Total	$800,000	100%

We will explore the following three options for distributing the cash flow from sale:

Funds available for distribution

Sale Price	$ 3,709,677	
Less Repayment of mortgage	2,090,050	
Real Estate & legal fees	148,387	(4%)
Proceeds from sale	1,470,780	
Return of equity	800,000	
Available to distribute	670,780	

Distribution of the funds "Available to distribute" which is $670,000

	Option 1	Option 2	Option 3
Accounting Firm	50%	38%	20%
Investor	50%	62%	80%
	100%	100%	100%

Distribution of the proceeds from sale for the three options

Sale Price	$	3,709,677
Less Repayment of mortgage		2,090,050
Real Estate & legal fees		148,387 (4%)
Proceeds from sale		1,470,780
Return of equity		800,000
Available to distribute		670,780

	Option 1	Option 2	Option 3
Accounting Firm	**50%** $335,390	**38%** $254,896	**20%** $134,156
Retun of Equity	300,000	300,000	300,000
Share of Sale Proceeds	**$635,390**	**554,896**	**434,156**
Investor	**50%** $335,390	**62%** $415,884	**80%** $536,624
Return of Equity	500,000	500,000	500,000
Share of Sale Proceeds	**$835,390**	**$915,884**	**$1,036,624**
Verification Proceeds from sale	$1,470,780	$1,470,780	$1,470,780

Option 1 Distribution of the sales proceeds
Accounting Firm 50%
Investor 50%

Accounting Firm. Annual cash outflow

Year	Mortgage Payment	Operating Costs (TIM's)	Total
1	152,017	112,000	264,017
2	152,017	115,360	267,377
3	152,017	118,821	270,838
4	152,017	122,385	274,402
5	152,017	126,057	278,074

Option No. 1 Accounting Firm, Net Cash flow. Own versus Lease

Year	Equity	Leasing	Owning	Cash Flow Difference	Cash Flow from Sale	Net Cash Flow
0	-300,000					-300,000
1		288,000	264,017	23,983		23,983
2		295,200	267,377	27,823		27,823
3		302,580	270,838	31,742		31,742
4		310,145	274,402	35,742		35,742
5		317,898	278,074	39,824	635,390	675,214
					Internal Rate of Return (IRR)	**23.95%**

Option No. 1 Investor Net Cash Flow.

Year	Equity	Annual Contribution	Cash Flow from Sale	Net Cash Flow
0	-500,000			-500,000
1		0		0
2		0		0
3		0		0
4		0		0
5			835,391	835,391
			Internal Rate of Return (IRR)	**10.81%**

Summary Option No. 1

Option No. 1 doesn't work. The accounting firm gets a return (IRR) of 21.25% compared to 10.81% for the investor which isn't a fair arrangement from the investor's perspective.

	Distribution	Internal Rate of Return (IRR)
Accounting Firm	50%	23.95%
Investor	50%	10.81%

Option 2. Distribution of the sales proceeds
Accounting Firm 38%
Investor 62%

Accounting Firm. Net Cash Flow

Year	Equity	Leasing	Owning	Cash Flow Difference	Cash Flow from Sale	Net Cash Flow
0	-300,000					-300,000
1		288,000	264,017	23,983		23,983
2		295,200	267,377	27,823		27,823
3		302,580	270,838	31,742		31,742
4		310,145	274,402	35,742		35,742
5		317,898	278,074	39,824	554,896	594,720
					Internal Rate of Return (IRR)	21.25%

Investor. Net cash flow

Year	Equity	Annual Contribution	Cash Flow from Sale	Net Cash Flow
0	-500,000			-500,000
1		0		0
2		0		0
3		0		0
4		0		0
5			915,884	915,884
			Internal Rate of Return (IRR)	12.87%

Summary Option No. 2
Distribution of the sale proceeds

Option No.	Accounting Firm		Investor	
1	50%	IRR: 23.95%	50%	IRR: 10.81%
2	38%	IRR: 21.25%	62%	IRR: 12.87%

Option 3. Distribution of the sales proceeds

Accounting Firm 20%
Investor 80%

Accounting Firm. Net Cash Flow

Year	Equity	Leasing	Owning	Cash Flow Difference	Cash Flow from Sale	Net Cash Flow
0	-300,000					-300,000
1		288,000	264,017	23,983		23,983
2		295,200	267,377	27,823		27,823
3		302,580	270,838	31,742		31,742
4		310,145	274,402	35,742		35,742
5		317,898	278,074	39,824	434,156	473,980
				Internal Rate of Return (IRR)		**15.70%**

Investor. Net Cash Flow

Year	Equity	Annual Contribution	Cash Flow from Sale	Net Cash Flow
0	-500,000			-500,000
1		0		0
2		0		0
3		0		0
4		0		0
5			1,003,065	1,003,065
			Internal Rate of Return (IRR)	**14.94%**

Summary and conclusions

Option No.	Accounting Firm		Investor	
1	50%	IRR: 23.95%	50%	IRR: 10.81%
2	38%	IRR: 21.25%	62%	IRR: 12.87%
3	20%	IRR: 15.70%	80%	IRR: 14.94%

Buy Out Value. End of five years Option No. 3

If the accounting firm wants to buy out the investor at the end of five years, how much money will they need under option No. 3 if they refinance the first mortgage using a 75% Loan to Value Ratio?

Property value at end of 5 years: $3,709,677
Outstanding mortgage balance: $2,090,510
Assume no real estate fees are paid. The real estate fees not paid are $148,387

Funds generated through refinancing

New mortgage $3,709,777 x 75% LTV	$3,709,677
Pay off the Outstanding balance	2,783,258
Funds generates through refinancing	$ 691,748

Cost to buy out the investor

Return of Equity	$ 500,000
Share of distribution (80%)	536,621
Share of real estate fees $148,387 x 80%	118,710
Payout to investor	**$1,155,331**
Funds available through refinancing	691,748
Additional funds to buy out the investor	**$463,583** (12% of the property value)

Investment Approach
Another approach is to treat the joint venture as business investment where the Accounting Firm pays market rents and the JV partners share in the cash flows based on their equity contributions which is $300,000 (38%) for the Accounting Firm and $500,000 for the Investor (62%).

If we look at the total investment the Internal Rate of Return (IRR) is 16.02% which means that both JV partners receive the same return (IRR) of 16%.

Overall investment cash flow. Internal Rate of Return (IRR): 16%

Net Cash Flow (Before Tax)

Year	Investment	Financing: Borrow	Financing: Paid Back	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (3,200,000)	$ 2,400,000	-	$ 23,983	-	$ (776,017)
Year 2 Jan-Year 2 Dec	-	-	-	27,823	-	27,823
Year 3 Jan-Year 3 Dec	-	-	-	31,663	-	31,663
Year 4 Jan-Year 4 Dec	-	-	-	35,663	-	35,663
Year 5 Jan-Year 5 Dec	-	-	(2,090,510)	39,823	3,561,290	1,510,603
					Total	$ 829,735

Financial Returns (Before Tax) with Financing
Internal Rate of Return (IRR) 16.02%

Accounting Firm (38%). Internal Rate of Return (IRR): 16%

Year	Equity	Share of Op Cash Flow	Share of Sale Proceeds	Net Cash Flow
	-300,000			-300,000
1		9,114		9,114
2		10,573		10,573
3		12,031		12,031
4		13,552		13,552
5		15,132	554,896	570,028
			Internal Rate of Return (IRR)	16%

Investor (62%) Internal Rate of Return (IRR): 16%

Year	Equity	Share of Op Cash Flow	Share of Sale Proceeds	Net Cash Flow
	-500,000			-500,000
1		14,870		14,870
2		17,250		17,250
3		19,631		19,631
4		22,111		22,111
5		24,690	915,884	940,574
			Internal Rate of Return (IRR)	16%

Accounting firm's perspective. Cash flow difference JV versus Investment approach

With the Investment approach to the joint venture arrangement the accounting firm pays market rents whereas with the joint venture option the accounting firm pays both the operating expenses (TIM's) and pays the mortgage which is less than the market rent.

Under the JV No. 3 option the annual cash flow for the accounting firm is less than the investment approach to the joint venture arrangement. Over the five years the accounting firm saves $159,115 with the joint venture option compared to the Investment option.

Accounting firm. Annual Savings with the joint venture

	Investment option Pays rent as a tenant	JV Option pays Op. Costs (TIM's) & Mortgage payments	Cash flow Difference
1	288,000	264,017	23,983
2	295,200	267,377	27,823
3	302,580	270,838	31,742
4	310,145	274,402	35,743
5	317,898	278,074	39,824
			$159,115

Summary and conclusion

	Accounting firm	Investor
Equity	$300,000 (38%)	$500,000 (62%)
Investment approach	Pays market rent	
	Shares 38% of op cash flows	Shares 62% op cash flow
	Receives 38% on sale of the	Receives 62% on sale of the
	of funds available to distribute	of funds available to distribute
Return on Investment (IRR)	**16%**	**16%**
Joint Venture Option No.3	Pays op expenses and the	
	mortgage payments	
	Receives 20% on sale of the	Receives 80% on sale of the
	funds available to distribute	funds available to distribute
Return on Investment (IRR)	**15.70%**	**14.94%**

Observations

Case study No. 2 illustrates the following:

1. If the acquisition works as an investment it will work as a joint venture. Conversely if the acquisition doesn't work as an investment it won't work as a joint venture

   When developing a joint venture the first test is to check that it works as an investment

2. There are many ways to structure a joint venture that is fair to all the investors in the JV

3. Developing the financial structure of the joint venture is a trial and error process. You try different financial arrangements until you find one that works for all the investors in the JV

   We explored three different options until we found option No.3 which worked

Joint Venture Case Study No. 3

You have a friend who has a manufacturing plant and leases 4,000 Sq. t of industrial space. The lease expires in approximately one year.

He owns an industrial site, which he bought six years ago for $200,000 which is now valued at $400,000.

The manufacturer would like to build and own his own building but require $200,000 to expand his operations. This would not be possible if he developed the property and moved in and rented the remainder of the space.

You are aware of an investor who is interested in real estate but has no development experience. Your idea is to build a 10,000 square foot building where the owner/tenant will take 4,000 square feet and the other 6,000 square feet will be rented out.

The building will cost $1,000,000 including financing, architectural fees etc. You think that a mortgage for $1,045,000 can be arranged and that the space will rent for $13 (NNN) per Sq. Ft per Yr.

The market value for the fully leased building is $1,500,000. It is estimated that the building can be sold in five years' time for $1,700,000.

You think it would be wise for the joint venture to have $45,000 of working capital as a contingency to cover unexpected expenses.

How would you go about putting this deal together? Prepare a discussion proposal for the first meeting between the manufacturer and the investor, which outlines the general terms of the joint venture.

Summary of the financial information.

Analysis Period	5 years
Original value of the land	$200,000
Current market value of the land	$400,000
Manufacturer needs for expansion	$200,000
Proposed development	10,000 square feet
Manufacture will rent	4,000 square feet (40%)
Remaining Space	6,000 square feet (60%)
Rental rate	$13 Sq. Ft per Yr. (NNN)
Development costs (Excl. land costs)	$1,000,000
Working capital	$45,000
Market value of the new building	$1,500,000
Sale Price in 5 years' time	$1,700,000
Mortgage $1,045,000	
Interest Rate: 6.50%	
Amortization: 25 years	

Possible solution

Joint Venture Exercise No 2.

Manufacturer/Investor and Investor

Objectives

To construct a win/win joint venture that;

a) Allows the manufacturer to receive $200,000 to expand his business

b) Reduces the risk to the investor and provides a better return on his equity than if he purchased a comparable building

The initial challenge is to calculate how much equity is needed from the investor.

There are two approaches to determine the equity needed from the investor:

1. Use a Source and Application of Funds Statement
2. Assume the joint venture buys the land at market value of $400,000

1. Use a Source and Application of Funds Statement

1. Use a Source and Application of Funds Statement

Source of Funds

	Guess	Revised
Assume the Investor contributes	$300,000	$200,000
From manufacturer	200,000	200,000
From the Investor	300,000	200,000
Financing. First mortgage	1,045,000	1,045,000
	1,545,000	1,445,000

Use of Funds

Development Costs	$1,000,000	$1,000,000
Working Capital	45,000	45,000
To the Investor/Manufacturer	400,000	400,000
	$1,445,000	$1,445,000
Excess Funds	100,000	-

Manufacture will use the $400,000 of funds as follows;

Invest in the development	$200,000
Retain to expand his business	200,000
Total	$400,000

His equity contribution is $200,000 ($400,000 – 200,000)

The second approach is to have the joint venture buy the land from the manufacturer at the market value for $400,000

Total cost, financing and equity contributions

Land		$400,000
Development		1,000,000
Working capital		45,000
	Total	$1,445,000
Less the financing		$1,045,000
Equity required		400,000
Split 50/50		$200,000

Investor/Manufacturer

Receives	$400,000
Uses to expand operations	200,000
Reinvests as equity	200,000

We will use $200,000 as the equity contribution of each investor

Double check your work

When carrying out investment and cash flow analysis which involves lots of numbers, it's always good idea to find ways to check you work to make sure you haven't made a mistake.

A good check is to develop the **Source and Application of Funds Statement** to make sure the money coming in is equal to the money going out, and that you haven't made a mistake.

The importance of checking your work. Bat and ball example

Question:
A bat and ball cost $1.10
The bat costs $1 more than the ball
What's the cost of the ball?

My answer

Cost of the ball $_____

Source:
Think Fast, Think Slow
Daniel Kahneman
Winner Nobel Prize in Economics

The litmus test

Does the project work as an investment?

If not, it won't work as a joint venture

Operating Cash Flow before Tax

Operating Cash Flow Yearly
Manufacturer Investor JV

	Year 1	Year 2	Year 3	Year 4	Year 5
CASH FLOW BEFORE TAX					
Potential Gross Income	**130,000**	**130,000**	**130,000**	**130,000**	**130,000**
Less: Vacancy & Credit Loss Allow.	-	-	-	-	-
Effective Gross Income	**130,000**	**130,000**	**130,000**	**130,000**	**130,000**
Operating Expenses	-	-	-	-	-
Net Operating Income	**130,000**	**130,000**	**130,000**	**130,000**	**130,000**
Less: Principal Payments	17,254	18,410	19,643	20,958	22,362
Interest payments	67,417	66,261	65,029	63,713	62,309
CASH FLOW BEFORE TAX	**45,329**	**45,329**	**45,329**	**45,329**	**45,329**

Net Cash Flow before Tax

Net Cash Flow (Before Tax)
Manufacturer Investor JV

Year	Investment	Financing: Borrow	Financing: Paid Back	Replacement Reserve Acct. Cash Flow: Additions	Replacement Reserve Acct. Cash Flow: Reductions	Operating Cash Flow (Before Tax)	Sale Proceeds (Before Tax)	Net Cash Flow (Before Tax)
Year 1 Jan-Year 1 Dec	$ (1,400,000)	$ 1,045,000	-	$ (45,000)	-	$ 45,329	-	$ (354,671)
Year 2 Jan-Year 2 Dec	-	-	-	-	-	45,329	-	45,329
Year 3 Jan-Year 3 Dec	-	-	-	-	-	45,329	-	45,329
Year 4 Jan-Year 4 Dec	-	-	-	-	-	45,329	-	45,329
Year 5 Jan-Year 5 Dec	-	-	(946,374)	-	45,000	45,329	1,700,000	843,955
							Total	$ 625,271

Working Capital

Financial Returns (Before Tax) with Financing	
Internal Rate of Return (IRR)	23.77%
Net Present Value (NPV) at 13.00%	$ 192,895
Modified Internal Rate of Return (MIRR)	20.82%
Short Term Financing Rate (Before Tax)	7.000%
Short Term Reinvestment Rate (Before Tax)	1.000%

Note: The Internal Rate of Return (IRR) of 23.77% includes the development profit

Joint Venture Summary

1. Each partner will have a 50% interest and will contribute $200,000 of equity

2. The building will be 10,000 sq. feet and the owner/tenant will lease 4,000 sq. feet (40%) at $13 per Sq. Ft (nnn) and will enter into a lease with a five year term and an option to renew for another five years at market rents

3. Tenant inducements will be based on current market inducements

4. A mortgage of $1,045,000 will be secured against the property, personally guaranteed by each partner

5. Each investor will receive 50% of the annual cash flows before tax to be distributed every three months. Losses will be shared 50/50

6. Working capital of $45,000 will be maintained as a buffer to cover unexpected expenditures or loss of revenue on vacant space and will be maintained at this level with a top up provision

7. In the event that one party does not contribute their share of an operating losses or the working capital, and the other investor contribute the defaulting amount, they will receive interest at 18%. **Top up provision**. Once the balance falls below $15,000 each investor has to contribute 50% of the cash required to return the balance to $45,000

8. Default clause. In the event that the defaulting partner has not repaid his share of the operating loss or working capital contribution with interest at 18% per year within six months, his shareholding will be reduced accordingly.

9. The investor/manufacture will receive $200,000

10. The profit from the sale of the property will be split 50/50 after;

    Paying off the mortgage and selling expenses

    Returning the equity to each partner

11. The joint venture will pay the following real estate fees

    Introduction fee of $_____

    Leasing fee of _____% for both the manufactures space and the vacant space

12. The joint partners will be paid going market rates for specific responsibilities such as project management, property management, accounting services etc.

12. Will enter into a buy/sell agreement

Summary of the advantages

Investor/manufacture

1. Receives a 50% interest in the building and receives $200,000 to expand his business

2. Receives approximately $23,000 a year before taxes from operations

3. Will be able to develop the site which would not be possible without and investor

4. Receives 23.77% Return (IRR)

I**nvestor**

1. Receives approximately $23,000 a year before taxes from operations

1. $23,000 a year before taxes from operations

2. Receives 23.77% Return (IRR)

3. His risk is reduced because 40% of the space is pre-leased to the investor/manufacturer

4. Likely a more favorable construction loan interest rate can be obtained, because 40% of the space has been pre-leased.

Analyzing complex real estate investments

In addition to joint ventures, there a many vehicles used, which allow investors with limited capital to invest in real estate such as syndications, TIC's (Tenants in Common), general and limited partnerships and equity participation opportunities etc.

These investment opportunities tend to be very complex and hard to analyze and riddled with management fees including hidden profits created by transferring the land from one entity to another.

One approach is to:

Analyze the investment as if you were doing it yourself.

Example:

You or a client is considering investing is a syndicated local shopping center where you will have a small interest.

To gain a perspective of whether the investment makes sense carryout the following analysis;

Find a similar property that is on the market and carryout an investment analysis and then compare the financial and risk returns against the syndicated project.

Often the syndicated investments are stacked in favor of the promoter or syndicator who has built in a lot of management and hidden fees making the investment unattractive compared to doing it yourself.

TIP

It is wise to keep real estate investments as simple as possible.

Complex investments are hard to analyze and may have complex financial and legal risks that are hard to assess.

Simple example.

Fee simple house with a mortgage
Condominiums with a mortgage
Co-operative
House or building on 50 years leased land

Each level gets more complex in terms of the legal rights and challenges

Same applies to commercial buildings

How to cut through the clutter

Look at opportunity by carrying out an arm's length analysis

Syndicated Shopping Center

1. Find a comparable property for sale
2. Carryout an investment analysis
3. How does the investment compare to the syndicated investment
4. Quick check. Compare purchase Price per Sq. Ft

Example:

Syndicated Investment: $410 psf.

Purchase directly	300
Difference	$110
Increase	37%

Is it worth paying 37% more for the syndicated investment?

Big Issue. Selling the interest

Is there a market for selling the interest?

Part interest in real estate investment can be very difficult to sell

Most likely the buyers are the other investors who may offer a "low ball price" for the interest

REITs and publicly traded investment and development companies

An alternate to investing in a general and limited partner is to invest in a Real Estate Investment Trust (REIT) or a publicly traded real estate investment or development company.

Selling shares in a general and limited real estate partnership is very difficult unless the price for the shares is low enough for the other investors to buy the shares.

In contrast with REITs and publicly traded real estate and development companies it is easy to sell the shares.

It's much easier to evaluate a publicly traded compared to a general and limited partnership where the share prices and audited financial statements are readily available.

Generally investing in a publicly traded entity such as a REIT is less risky than investing in a general and limited real estate partnership.

Another option is REIT Indexed funds or real estate mutual funds which consist of a portfolio of REITs and real estate investment and development companies

Introduction to Waterfall Distributions

Waterfall distributions, which describe how profits will be distributed, are used in equity participation and joint venture deals involving a 'Promoter or manager" and "Equity Investors".

The objectives of the promoter are to:

1. To reduce their investment equity. Range 2% to 10%
2. To significantly increase their return (IRR)
3. To release capital for other ventures
4. Perhaps create lucrative management fees

Example

A real estate development company has built and leased a successful regional shopping center. The company wants to keep an interest in the project but would like to get most of the equity out in order to develop more properties and they wish to do this by bringing in equity partners.

These deals are structured using "waterfall distributions" which refers to a hierarchy of how funds will be distributed to the promoter and to the equity investors. The general framework for the waterfall distribution is:

1. Capital or equity contributions

Typically Promoter 5% to 10%, equity investors 90% to 95%

2. Distribution of annual cash flow

a) Preferred return on equity. Usually 7% to 8%
b) How the remaining cash will be distributed?
   a. Applied to the outstanding balance of the equity or:
   b. Treated as a profit and distributed based on the equity or capital contributions

Example:
Equity: $1,000,000 Preferred Interest Rate: 7% = $70,000
Cash Flow $130,000

Cash flow	$130,000
Less: Preferred interest rate	70,000
Remaining cash flow	$ 60,000

Distribution of the remaining cash flow of $60,000

a) Applied to reduce the equity

Equity	$1,000,000
Less:	60,000
Balance in the equity account	$940,000

Next year the preferred interest is $940,000 x 7% = $65,800

b) The remaining cash flow of $60,000 is distributed to the equity investors as a profit rather than a partial repayment of the equity contribution

3. Distributions of the sale proceeds

Sale price
Less: Closing costs (real estate and legal fees)
Outstanding balance of the mortgage
Unpaid preferred interest
Outstanding equity balance
Proceeds from sale

The waterfall distribution then specifies how the proceeds from sale will be distributed.

As an example:
Promoter: 30%
Equity investor: 70%

The waterfall distribution approach provides an incentive to the promoter to increase the value of the property because the big payday for the promoter is when the property is eventually sold or perhaps refinanced.

Carried Interest

The delaying of profits to the promoter is sometimes called “Carried Interest”, “Carry “, “Promote” or a “Performance Fee”.

It is the share of the profits from the investment paid to the promoter in excess of the amount the promoter contributes to the partnership.

As an example, the promoter may contribute 10% of the equity but receive 30% of the proceeds from sale

The origins of the term ”Carried Interest” dates back to the 16th century where a ship’s captain would take a 20% share of the profits from the **carried goods** to pay for transportation and provide a profit commensurate with the risks of sailing the oceans.

In order to receive “carried interest” the promoter must first:

1) Pay the agreed upon preferred interest rate based on the equity contributions E.g. 7%

2) Return the equity contributions or capital provided by the equity investor

From the equity investor’s perspective they are receiving a preferred interest annually of 7% to 8% based on the balance in their equity account.

Note that this is a “preferred interest”. It is not a guaranteed interest. If there is not enough cash flow to fully pay the preferred interest then the outstanding amount is carried forward until there is sufficient cash flow to cover the unpaid preferred interest.

Refinancing

An interesting question is how to distribute the funds generated by refinancing the property between the promoter and the equity investors.

With refinancing the promoter is replacing capital (equity) with debt.

The equity investors would prefer the refinancing proceeds be applied to reducing the balances in the equity accounts.

On the other hand, the promoter may argue that the ability to refinance the property is because of an increase in the market value property and should be distributed as a profit from sale with say 30% going to the promoter and 70% to the equity partners.

One compromise is to split the proceeds from refinancing into two parts:

1) A proportion of the refinancing proceeds based on the increase in the market value of the property is treated as a profit

2) The remaining funds from refinancing is used to reduce the balances in the equity accounts

How the proceeds from refinancing are distributed between the promoter and the equity investors needs to be specified in the legal agreement between the promoter and the equity partners.

“Whole Fund” versus “Deal by Deal” waterfall arrangements

If the promoter has more than one property they may place all the properties in one fund called a ‘Whole Fund”. The other option is two treat each property individually on a “deal by deal” basis.

Whole Fund

With a “Whole Fund” there are a number of properties that form the investment pool.

With a “whole fund” the promoter doesn’t receive any “carried interest” or profits from a sale of a property within the whole fund until the equity partners:

1. Have receive their preferred interest rate

2. Their equity or capital contributions have been fully repaid

Deal by Deal
With a deal by deal waterfall arrangement the promoters receives their “carried interest” or share of the sales proceeds when the property is sold.

For more information on Waterfall Distributions and “Whole Fund” versus “Deal by Deal” please see the article in the appendices.

Waterfall Distributions. Case study

The “Promoter” had acquired a large quality rental apartment complex and wants to bring in an equity partner in order to release capital to acquire more properties.

Objectives

1) Determine how the waterfall distribution works

2) Identify hidden or unusual fees

3) Review the revenue, expense and vacancy projections. Are they realistic?

4) Determine the Internal Rate of Return (IRR) for the:
   Property
   Equity investors
   Promoter

5) Carryout sensitivity analysis

6) Identify the investment risks

7) Enable the equity investor to decide whether they should Investit in the deal

The waterfall structure

Equity Investment
Promoter: 10%
Equity investors: 90%

Financing
First five years: Interest only payment
Starting year six. Amortized over 30 years
Favorable interest rate. Locked in for ten years

Maintenance Reserve: $90,000 per year

Hidden fees
No hidden fees or transfer profits were identified. Property management fees were typical for this type of property. No red flags.

Legal concerns

Cash call provision. A troublesome clause but $90,000 per year compounding at 3% was being contributed to the maintenance reserve account.

Potential to be diluted if the promoter has to raise cash for a major unexpected expenditure or large loss. The probability of this happening is low. There should be plenty of funds available in the maintenance reserve to cover unexpected expenditures or losses. The alternate would be to refinance or add a second mortgage.

Limited voting rights
The equity investors have very limited rights and a largely passive. They are relying on the promoter to create and manage a profitable investment

The above clauses are normal provisions the equity participation deals.

Revenue, expense an vacancy projections

Revenue projections provided by the promoter seemed realistic.

The Operating Expense ratio was around 43% each year for the ten years. We increased it from 43% to 53% over the ten year period to reflect the increases in the operating expenses as the building aged.

Vacancy allowance was around 5.50% which seemed realistic for the location

Mortgage projections
The initial cash flow proformas provided the promoter were 5 years but this didn't show the impact of the mortgage changing from an interest only loan to a 30 year fully amortized loan starting is year six.

We requested and received a ten year analysis from the promoter which we used as the basis for the ten year analysis.

Distribution of the annual cash flows

1) Promoter and Equity Partner each get a preferred return of 7% based on their equity contributions which is 10% for the promoter and 90% for the equity investors

2) Remaining cash flow is used to reduce the equity balance. This approach increases the yield to the promoter because there is less equity to pay back when the property is sold where the promoter gets back the "Carried Interest"

Cash flow from sale used to:

1. Pay off the outstanding balance of the mortgage

2. Pay the closing costs such as real estate and legal fees

3. Payback the outstanding equity balances to the promoter and equity investor

4. Sale proceeds seemed to be split 70% to the equity investor and 30% to the promoter but this didn't match the number showing in the spreadsheet. It was discovered that the split of the sale proceeds was:

    Equity investors: 70% x 90% = 63% not 70%
    Promoter: 37%

Financial analysis results

The following summarizes the overall financial results.

Promoter's proforma
Acquisition Cap Rate: 5.26%

	Sale Cap Rate	IRR
Overall Return	**6.20%**	**12.50%**
Equity investor's return	**6.20%**	**10.74%**
Promoter's return	**6.20%**	**17.50%**

Revised projections and sensitivity analysis

	Sale Cap Rate	IRR
Equity investor's return	**6.20%**	**8.59%**
	6.50%	**7.84%**
	7.00%	**6.99%**
	7.50%	**5.51%**

The promoters 10 year analysis using a sale Cap Rate of 6.20% predicts an IRR of 10.74% return for the equity investors whereas the revised analysis suggests the IRR is more likely to be around 8.59% which is 20% less than the promoter's estimate of the return (IRR) for the equity investors.

The promoter's return (IRR) is 17.50% compared to the equity investor's return (IRR) of 10.74%

Sensitivity analysis

The financial results are highly dependent on the assumption made as the Cap Rate used to calculate the potential sale price at the end of 10 years using the Net Operating Income (NOI) in year 11.

If the sale Cap Rate changes from 6.20% to 7.50% the IRR changes from 8.59% to 5.51% which is less than the preferred return of 7%.

If the Cap Rate on sale is 6.50% there are sufficient funds to pay the outstanding balance of the equity of $21,285,550 and provide a profit to the investors of $2,637,901.and an IRR of 7.84%

If the Cap Rate is higher than 7.00% then there may not be any profits from the sale to distribute. In this case the most likely decision would be to keep the property rather than sell which would allow the 7% preferred interest rate to continue.

When the principal payments start in year 6 there is not enough cash flow to fully pay the 7% preferred interest but the unpaid preferred interest is recovered in year 7

Supply, Demand and Cap Rates

The assumption as to the Cap Rate on sale has a major impact on the financial viability of the equity investment.

Currently the Cap Rates for rental apartment buildings are low but could increase over the next ten years caused by:

1) An oversupply in many markets created by overbuilding new units. An oversupply is already occurring in some markets and may worsen over the next few years
2) Due to the oversupply, vacancies may increase and rent rate increases may slow down or even decline
3) Mortgage rates are at all-time lows and likely will increase over the next ten years which may cause a rise cap rates

These factors suggest that today's low cap rates are likely to increase over the next ten years and future Cap Rates are a major consideration as to whether to invest in the promoter's properties

Cash Flow concerns
In year 6 there is not enough cash flow to pay the 7% preferred interest rate but the unpaid preferred interest is recovered in year 7.

Conclusion

The probability of receiving the 7% preferred return and a 5.5% to 7.0% Internal Rate of Return (IRR) over the ten years is likely high.

Achieving an Internal Rate of Return (IRR) for the investors higher than 7.00% is more questionable as it depends on: the following assumptions:

1) Cap Rate on Sale
2) The estimated Net Operating Income (NOI) in year 11

The Cap Rate on sale and the Net Operating Income (NOI) are very difficult to predict particularly given the likely over building of rental apartment buildings over the next few years. Both have a major impact on the financial returns (IRR).

Depending on the assumption as to the Cap Rates on sale and the Net Operating Income (NOI) the equity investor's Internal Rate of Return (IRR) could range from 5.50% to 10% or higher.

The promoters return (IRR) is around 17% which reflects receiving 37% of the sale proceeds while only contributing 10% of the equity which is called "Carried Interest"

Variations In Structuring "Whole Fund" And "Deal By Deal" Carried Interest Or Promote In Real Estate Funds And Joint Ventures

Nathaniel M. Marrs, Louis D. Hellebusch and Krishnakshi Das

A number of variations in distribution waterfall terms enable managers and investors to tailor the timing of distributions of profts to the particular characteristics of their fund or joint venture, including the fund's or joint venture's investment strategy and expected fnancial performance. In this article, the authors analyze these variations and explore some of the considerations underpinning their use.

Disproportionate profit-sharing for managers of real estate funds and joint ventures,[1] called ''carried interest'' or ''promote,''[2] is typically thought of as calculated on either a ''deal by deal'' or a ''whole fund'' basis. This simple dichotomy, however, conceals a number of variations which enable fund managers and investors to tailor the timing of distribution of profits to the particular characteristics of their fund, including the fund's investment strategy and expected financial performance. This article analyzes these variations and explores some of the considerations underpinning their use. Perhaps most critically, an appropriately constructed fund distribution waterfall can assist in aligning the incentives of managers and investors and properly motivate and compensate the individuals charged with executing a fund's investment mandate.

Nathaniel M. Marrs, a partner in the Chicago office of Kirkland & Ellis LLP, focuses his practice on corporate and commercial real estate transactions of all types, with a specific focus on U.S. and international private real estate fund formations and investments and complex joint venture arrangements. Louis D. Hellebusch and Krishnakshi Das are associates in the firm's Chicago office. The authors can be reached at nmarrs@kirkland.com, lhellebusch@kirkland.com and kdas@kirkland.com, respectively.

The Basics: Manager Carried Interest and The Fund Distribution Waterfall

A manager's carried interest is one of the most important financial terms negotiated in the formation of a fund. Quite often, it is the most significant component of a manager's expected incentive compensation.[3] Commonly, a manager will not be entitled to carried interest until each investor in the fund recoups its applicable capital contributions (whether for a specific deal or for the whole fund) and achieves a preferred return thereon. Thereafter, a manager will begin to receive carried interest distributions equal to a percentage (or percentages) of remaining fund profits. Although the specific investor preferred return and manager carried interest percentages vary, a common

preferred return for real estate funds (at least successful, opportunistic real estate funds) is eight percent (8%) per annum, compounded annually, and a common overall carried interest percentage is twenty percent (20%).[4] After achieving the preferred return and return of capital for investors, the next question that arises is precisely how much of the next dollar of profits is given to the manager versus the investors. A manager may be entitled to up to one hundred percent (100%) of the next dollar of profits until such time as the manager has received twenty percent (20%) of the fund's total profits (known as a ''catch-up''). We will assume for all discussion purposes and examples throughout the remainder of this article that, after investors receive a return of their applicable invested capital (again, whether for a specific deal or for the whole fund), plus a preferred return of eight percent per annum (compounded annually) thereon, 100 percent of all profits of the fund will be distributed to the manager until the manager has received 20 percent of the total profits of the fund (a so-called ''100 percent catch-up'') and, thereafter, all additional profits will be distributed 20 percent to the manager and 80 percent to the investors.[5]

Overview of Whole Fund versus Deal By Deal Waterfall Models

After determining the basic features discussed above, the parties must decide whether carried interest will be distributed on a deal by deal or on a whole fund basis. Under the deal by deal model, returns are generally calculated for each investment, and the manager receives its carried interest as profits are realized on the particular investment. In contrast, under a whole fund model, the manager does not receive carried interest distributions until the investors receive distributions equal to their total capital contributions to the entire fund and a preferred return on all such contributions. Assuming that a fund incorporates a so-called ''claw-back'' feature,[6] both the deal by deal model and the whole fund model should result in the same aggregate sharing of profits over the life of the fund, with the only variable being the timing of receipt of such profits by the manager—earlier for a deal by deal model and later for a whole fund model. Of course, timing is everything as they say, and a number of interesting variations of the whole fund and deal by deal waterfall models can be employed in different circumstances to address different goals.

Income Source Variations on Waterfalls

One potential variation in carried interest arrangements is based on the source of income generated by a fund. The most common income source variation utilized in real estate funds is based on a distinction between ''current income'' (e.g., rents, hotel room revenue, and other forms of operating profit) and ''disposition proceeds'' (i.e., income resulting from the sale or other disposition of a fund's underlying investments). Under most real estate fund distribution waterfalls (whether structured to provide carried interest on a whole fund or on a deal by deal basis), current income simply flows through the same distribution waterfall as any other type of income. In contrast, those funds that distinguish between these different sources of income usually do so by creating separate distribution waterfalls, one governing the distribution of current income and the other governing the distribution of disposition proceeds. As we will explore in more detail, this type of distinction can be used in various circumstances to encourage a manager to execute the fund's mandate more efficiently, particularly for current income focused funds.

In the remainder of this article, we will review various possible forms (and combinations of forms) of these different models in detail and consider how their use affects the timing of distributions of profits to fund managers and investors.

The Whole Fund Model and Variations

Basic Whole Fund Model

In the basic whole fund model distribution waterfall, each investor must recoup its total capital contributions to the fund and receive a specified preferred return on those total contributions before the manager is entitled to receive any carried interest. In the simple illustration in Figure 1, we assume a fund with one investor made Investment A in Year 1 for $5 million, continued to make investments over the intervening years, such that the investor had contributed a total of $100 million as of the last day of Year 4, and that Investment A was sold in Year 4 for $12 million, with the resulting proceeds distributed at that time.

Figure 1 Basic Whole Fund Model		
Year 4: Total Capital Invested	$	100,000,000.00
Year 4: Sale of Investment A	$	12,000,000.00
Cost of Investment A	$	5,000,000.00
Profits	$	7,000,000.00
Distributions		
Return of Capital	$	12,000,000.00
Preferred Return	$	-
Manager Catch-Up	$	-
Investor - 80% of Residual	$	-
Manager - 20% of Residual	$	-
Total Distributions to Investor	$	12,000,000.00
Total Distributions to Manager	$	-

Because the distribution waterfall reflected in Figure 1 is based on a whole fund model, the entire $12 million is distributed to the investor as return of capital. The manager will not receive a share of profits until the investor has received its entire capital contribution of $100 million plus the eight percent preferred return thereon, presumably following subsequent sales. The whole fund model is generally the most favorable to investors from a time value of money perspective since it defers distributions of carried interest to managers, and investors therefore receive more distributions of fund profits sooner.

Whole Fund, Income Source Variation

As noted above, the most common income source based variation utilized in real estate funds distinguishes current income and disposition proceeds. Specifically, a manager applying this variation to a whole fund model waterfall is permitted to receive carried interest from distributions of current income (but not distributions of disposition proceeds) as soon as investors receive the preferred return on all invested capital, even if investors have not recouped any of their capital contributions. Figure 2 is a basic illustration of this variation on the whole fund model. For purposes of this example we assume a fund with one investor who made total contributions to the fund of $100 million, that the fund distributes $12 million of current income received by the fund from the operation of its investments on the last day of Year 1. We also assume that Investment A was purchased on the first day of Year 1 for $5 million and sold on the last day of Year 1 for $12 million. For simplicity, we assume that the entire $100 million was contributed on the first day of Year 1 and that there have been no distributions prior to the last day of Year 1.

Figure 2 Whole Fund, Income Source Variation Model				
Year 1 (beginning): Total Capital Invested			$	100,000,000.00
Year 1 (end): Total Current Income			$	12,000,000.00
Year 1 (end): Sale of Investment A			$	12,000,000.00
Cost of Investment A			$	5,000,000.00
Profits			$	7,000,000.00
Distributions				
		Current Income		Disposition Proceeds
Return of Capital		N/A	$	12,000,000.00
Preferred Return	$	8,000,000.00	$	-
Manager Catch-Up	$	2,000,000.00	$	-
Investor - 80% of Residual	$	1,600,000.00	$	-
Manager - 20% of Residual	$	400,000.00	$	-
Total Distributions to Investor			$	21,600,000.00
Total Distributions to Manager			$	2,400,000.00

In the case of Figure 2, the manager immediately receives some portion of its carried interest on the current income generated by the fund ($2.4 million), while the capital invested in each deal is returned pursuant to a separate disposition proceeds waterfall (in this case, $12 million). Note that because the manager is entitled to take carried interest on current income before any investments are realized (and before capital invested in any investments is returned), this model increases the need for a claw-back upon liquidation of the fund (relative to the basic whole fund model) in order to ensure the proper aggregate sharing of profits between the fund manager and fund investors.[7] This form of a whole fund waterfall represents a compromise between the basic whole fund and deal by deal approach: the manager obtains a more rapid monetization of carried interest from current income, while the separate disposition proceeds waterfall continues to operate in the same manner as described above in the basic whole fund model (and investors accordingly receive a full return of all capital contributed to the fund, plus preferred return thereon, from disposition proceeds resulting from realized investments prior to the manager receiving any carried interest distributions in relation thereto). Of course, the extent to which a manager's carried interest is monetized under this particular model depends upon the level of current income generated by the fund's underlying investments.

A Closer Look: Refinancing Proceeds as Distributable Profits

The rationale for the distinction between current income and disposition proceeds is the notion that return of capital is only realized upon the sale of an asset and therefore current income should be treated as pure profit (or at least only applied to recoup preferred return versus capital). This reasoning is sometimes extended to distributable proceeds realized from a refinancing transaction. In a typical refinancing transaction that would result in distributable proceeds, a manager replaces existing equity in an investment with additional debt, and the proceeds from the refinancing are then distributed to investors. Managers sometimes take the position that such proceeds constitute profits akin to current income and should be distributed 80 percent to investors and 20 percent to the manager as carried interest from the first dollar of proceeds (or after only the preferred return has been recouped), whereas investors favor treating the proceeds as return of capital, thereby normally delaying any carried interest payments until the final sale of the investment. One compromise is to treat a pro rata portion of the proceeds of such transaction as a return of capital based on a ratio of the total capital funded to such investment to the fair value implied by the refinancing proceeds. This middle road gives the manager credit for the value it has realized, but does not treat the full proceeds as profits.

The Deal by Deal Model and Variations

Strict Deal by Deal Model

In the strict deal by deal model, each deal stands alone, and the profits and losses of each deal are insulated from the profits and losses of other investments made by the fund. Under this model, the manager receives carried interest from proceeds of an individual investment as soon as each investor recoups its capital contribution and corresponding preferred return attributable to such investment. The manager is entitled to keep any carried interest distributions regardless of whether the fund's other investments are (or even the fund as a whole is) profitable.[8] This model essentially provides a manager a series of independent options on investment profits—managers only have the possibility of being rewarded for making good investments and have no possibility of being punished for making bad ones.[9] Accordingly, this model is rarely seen in discretionary real estate funds in the marketplace today.[10]

Deal by Deal, Realized Loss Model

Due to the concerns with the strict deal by deal model discussed above, the more common permutation of a deal by deal approach includes a make-up for realized losses. Under this model, the first tier of the fund waterfall requires a return of capital invested in all realized investments (plus a preferred return thereon), but not capital invested in unrealized investments (or a preferred return with respect thereto). Therefore, if an investment has been realized at a loss,[11] distributions from future realized deals will be required to make up for such loss prior to reaching any other tier of the waterfall. Figures 3.1 and 3.2 illustrate the basics of this model. In Figure 3.1, we assume the fund makes two investments—Investment A in which it invests $10 million and Investment B in which it invests $15 million. For simplicity, we assume all capital was funded on the first day of Year 1, that Investment A's proceeds were distributed on the first day of Year 2 and Investment B's proceeds were distributed on the first day of Year 3, with no other distributions made during such period. The fund then first sells Investment A and realizes distributable proceeds of $8 million. It then sells Investment B and realizes distributable proceeds of $25 million. The assumptions for Figure 3.2 are the same, except that the fund sells Investment B first and Investment A second.

Invested Capital and Realized Proceeds (Figures 3.1 and 3.2)

Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Realized Proceeds	$	8,000,000.00	Realized Proceeds	$	25,000,000.00

Figure 3.1
Deal by Deal, Realized Loss Model - Scenario 1

	Investment A		Investment B			
Realized Proceeds Y1	$	8,000,000.00				
Realized Proceeds Y2			$	25,000,000.00		
	Investment A - Unpaid Preferred Return		Investment A - Distributions		Investment B - Unpaid Preferred Return	Investment B - Distributions
Year 1						
Return of Capital			$	8,000,000.00		$ -
Preferred Return	$	800,000.00	$	-	$ 1,200,000.00	$ -
Manager Catch-Up			$	-		$ -
Investor - 80% of Residual			$	-		$ -
Manager - 20% of Residual			$	-		$ -
Year 2						
Make-Up for Realized Loss on Investment A						$ 2,000,000.00
Return of Capital						$ 15,000,000.00
Preferred Return	$	1,424,000.00			$ 2,800,000.00	$ 4,224,000.00
Manager Catch-Up						$ 1,056,000.00
Investor - 80% of Residual						$ 2,176,000.00
Manager - 20% of Residual						$ 544,000.00
Totals						
Total Proceeds to Investor	$	31,400,000.00				
Total Proceeds to Manager	$	1,600,000.00				

Figure 3.2
Deal by Deal, Realized Loss Model - Scenario 2

	Investment A		Investment B			
Realized Proceeds Y1	$	25,000,000.00				
Realized Proceeds Y2			$	8,000,000.00		
	Investment A - Unpaid Preferred Return		Investment A - Distributions		Investment B - Unpaid Preferred Return	Investment B - Distributions
Year 1						
Return of Capital			$	-		$ 15,000,000.00
Preferred Return	$	800,000.00	$	-	$ 1,200,000.00	$ 1,200,000.00
Manager Catch-Up			$	-		$ 300,000.00
Investor - 80% of Residual			$	-		$ 6,800,000.00
Manager - 20% of Residual			$	-		$ 1,700,000.00
Year 2						
Return of Capital			$	8,000,000.00		
Preferred Return	$	1,664,000.00	$	-	$ -	
Manager Catch-Up			$	-		
Investor - 80% of Residual			$	-		
Manager - 20% of Residual			$	-		
Totals						
Total Proceeds to Investor	$	31,000,000.00				
Total Proceeds to Manager	$	2,000,000.00				

In the scenario presented in Figure 3.2, proceeds resulting from later, realized investments would be distributed first to the investor to make up the $2 million loss on Investment A. Figure 3.2 also illustrates why a claw-back is required to preserve the proper aggregate carried interest percentage in a deal by deal model. After the distribution of proceeds from Investment A in the Figure 3.2 example, the total profits of the fund were $8 million rather than $10 million and the manager has received $400,000 too much in carried interest. Without a claw-back, the manager would never be required to return this excess.

It is important to note that, under most versions of this waterfall model, current income earned before any investments have been realized is applied directly to carried interest and ''skips'' the return of capital and preferred return tiers of the waterfall. Furthermore, later distributions made in relation to realized investments are generally not required to make up such prior payments of carried interest on current income, and, absent a claw-back, a manager is not required to give back any portion of such current income carried interest following subsequent investment losses. As a result, this waterfall is also quite pro-manager, particularly when employed by a fund generating significant current income.

Deal by Deal, Realized Loss Model—Income Source Variations

As in the case of a whole fund model waterfall, the deal by deal, realized loss model waterfall can be split into two waterfalls so that current income from an individual investment is treated differently from disposition proceeds resulting from the sale of such investment. One possibility is to utilize a ''whole deal'' approach for current income, with current income from each investment going first as a return of capital funded to all realized investments, then as a return of capital with respect to the capital invested in that particular investment (plus preferred return thereon), prior to allowing any carried interest distributions with respect

to current income. Another possibility is to provide that current income goes first to return capital funded to all realized investments, then to the preferred return (but not return of capital) on capital invested in the particular investment generating such income, prior to allowing any carried interest distributions with respect to current income.[12] The important distinction between these two approaches is that, as long as there have been no realized losses, the first approach requires a return of capital plus preferred return with respect to an investment before permitting distributions of carried interest with respect to the current income generated by such investment, whereas the second approach only requires a recoupment of preferred return with respect to the capital invested in the investment generating current income before permitting distributions of carried interest with respect to such income. Like the basic deal by deal, realized loss model, all current income is applied directly to profits and the manager's carried interest and ''skips'' the return of capital tier prior to the sale of a fund's first investment (although, as noted, the preferred return on such capital must first be recouped). The treatment of disposition proceeds is the same under both approaches (and is the same as the basic deal by deal, realized loss model).

Figures 4.1 and 4.2 illustrate these two approaches. For purposes of Figures 4.1 and 4.2, we assume that the fund makes two investments on the first day of Year 1, Investment A, in which it invests $10 million and Investment B, in which it invests $15 million. Investment A generates $1.1 million, $0.65 million, and $0.65 million over a three year holding period and is sold on the last day of Year 3 for $7.9 million. Investment B generates $1.6 million, $1.6 million, $1.8 million and $2 million over a four year holding period and is sold on the last day of Year 4 for $25 million. All distributions are made on the first day of the year following that in which the funds are available, and current income is distributed prior to disposition proceeds in years where an investment is sold.

Figure 4.1: ''Whole Deal'' Income Source Variation

Invested Capital and Realized Proceeds (Figures 4.1 and 4.2)

Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Current Income Y1	$	1,100,000.00	Current Income Y1	$	1,600,000.00
Current Income Y2	$	650,000.00	Current Income Y2	$	1,600,000.00
Current Income Y3	$	650,000.00	Current Income Y3	$	1,800,000.00
Realized Proceeds Y3	$	7,900,000.00	Current Income Y4	$	2,000,000.00
			Realized Proceeds Y4	$	25,000,000.00

Figure 4.1

Deal by Deal, Whole Deal Income Source Variation

Distributions

	Investment A - Unpaid Preferred Return	Investment A - Current Income Distributions	Investment A - Disposition Proceeds Distributions	Investment B - Unpaid Preferred Return	Investment B - Current Income Distributions	Investment B - Disposition Proceeds Distributions
Year 1						
Investor - Return of Capital		$ 1,100,000.00			$ 1,600,000.00	
Investor - Preferred Return	$ 800,000.00	$ -		$ 1,200,000.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 2						
Investor - Return of Capital		$ 650,000.00			$ 1,600,000.00	$ -
Investor - Preferred Return	$ 1,576,000.00	$ -		$ 2,368,000.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 3						
Investor - Return of Capital		$ 650,000.00	$ 7,600,000.00		$ 1,800,000.00	
Investor - Preferred Return	$ 2,362,080.00	$ -	$ 300,000.00	$ 3,501,440.00		$ -
Manager - Catch Up		$ -				$ -
Investor - 80% of Residual		$ -				$ -
Manager - 20% of Residual		$ -				$ -
Year 4						
Investor - Return of Capital		$ -			$ 2,000,000.00	$ 8,000,000.00
Investor - Preferred Return	$ 2,227,046.40	$ -		$ 4,021,324.80		$ 6,248,371.20
Manager - Catch Up		$ -				$ 1,637,092.80
Investor - 80% of Residual		$ -				$ 7,291,628.80
Manager - 20% of Residual		$ -				$ 1,822,907.20

Total Distributions

Total Distributions to Investor	$	38,840,000.00
Total Distributions to Manager	$	3,460,000.00

Figure 4.2: Preferred Return Only Income Source Variation

Invested Capital and Realized Proceeds (Figures 4.1 and 4.2)

Investment A		Investment B	
Capital Invested	$ 10,000,000.00	Capital Invested	$ 15,000,000.00
Current Income Y1	$ 1,100,000.00	Current Income Y1	$ 1,600,000.00
Current Income Y2	$ 650,000.00	Current Income Y2	$ 1,600,000.00
Current Income Y3	$ 650,000.00	Current Income Y3	$ 1,800,000.00
Realized Proceeds Y3	$ 7,900,000.00	Current Income Y4	$ 2,000,000.00
		Realized Proceeds Y4	$ 25,000,000.00

Figure 4.2
Deal by Deal, Preferred Return Only Income Source

Distributions	Investment A - Unpaid Preferred Return	Investment A - Current Income	Investment A - Disposition Proceeds	Investment B - Unpaid Preferred Return	Investment B - Current Income	Investment B - Disposition Proceeds
Year 1						
Investor - Return of Capital		N/A			N/A	
Investor - Preferred Return	$ 800,000.00	$ 800,000.00		$ 1,200,000.00	$ 1,200,000.00	
Manager - Catch Up		$ 200,000.00			$ 300,000.00	
Investor - 80% of Residual		$ 80,000.00			$ 80,000.00	
Manager - 20% of Residual		$ 20,000.00			$ 20,000.00	
Year 2						
Investor - Return of Capital		N/A			N/A	
Investor - Preferred Return	$ 720,000.00	$ 650,000.00		$ 1,120,000.00	$ 1,120,000.00	
Manager - Catch Up		$ -			$ 280,000.00	
Investor - 80% of Residual		$ -			$ 160,000.00	
Manager - 20% of Residual		$ -			$ 40,000.00	
Year 3						
Investor - Return of Capital		N/A	$ 7,900,000.00		N/A	
Investor - Preferred Return	$ 675,600.00	$ 650,000.00	$ -	$ 1,040,000.00	$ 1,040,000.00	
Manager - Catch Up		$ -	$ -		$ 260,000.00	
Investor - 80% of Residual		$ -	$ -		$ 400,000.00	
Manager - 20% of Residual		$ -	$ -		$ 100,000.00	
Year 4						
Make-Up for Realized Losses					$ 2,000,000.00	$ 100,000.00
Investor - Return of Capital					$ -	$ 15,000,000.00
Investor - Preferred Return	$ 411,648.00			$ 800,000.00	$ -	$ 1,211,648.00
Manager - Catch Up					$ -	$ 627,912.00
Investor - 80% of Residual					$ -	$ 6,448,352.00
Manager - 20% of Residual					$ -	$ 1,612,088.00

Total Distributions	
Total Distributions to Investor	$ 38,840,000.00
Total Distributions to Manager	$ 3,460,000.00

Note that in Figure 4.2 the manager receives carried interest as early as Year 1, and in Year 4 current income from Investment B is applied to return of capital from Investment A, which has been realized, prior to being applied to the preferred return.

A Hybrid Model: Full Current Yield Income Source Variation

The final ‘‘hybrid’’ income source variation on the deal by deal, realized loss model calculates the required preferred return for current income distributions on all capital invested in the fund at the time a distribution is made, rather than on the capital invested in the particular investment generating the current income being distributed. Essentially, this model distributes current income on a whole fund basis and disposition proceeds on a deal by deal basis. Once again, the disposition proceeds waterfall is the same as the basic deal by deal, realized loss model (and thus calculates the preferred return payable via disposition proceeds only in relation to realized investments).

Figure 5 provides an example of such a waterfall. For purposes of Figure 5, we assume (as with Figures 4.1 and 4.2) that the fund makes two investments on the first day of Year 1: Investment A, in which it invests $10 million, and Investment B, in which it invests $15 million. Investment A generates $1.1 million, $0.65 million and $0.65 million over a three year holding period and is sold on the last day of Year 3 for $7.9 million. Investment B generates $1.6 million, $1.6 million, $1.8 million and $2 million over a four year holding period and is sold on the last day of Year 4 for $25 million. All distributions are made on the first day of the year after that in which the funds are available, and current income is distributed prior to disposition proceeds in years where an investment is sold.

Figure 5: Full Current Yield Income Source Variation

Invested Capital and Realized Proceeds (Figure 5)

Investment A			Investment B		
Capital Invested	$	10,000,000.00	Capital Invested	$	15,000,000.00
Current Income Y1	$	1,100,000.00	Current Income Y1	$	1,600,000.00
Current Income Y2	$	650,000.00	Current Income Y2	$	1,600,000.00
Current Income Y3	$	650,000.00	Current Income Y3	$	1,800,000.00
Realized Proceeds Y3	$	7,900,000.00	Current Income Y4	$	2,000,000.00
			Realized Proceeds Y4	$	25,000,000.00

Figure 5
Hybrid Model

Distributions

	Unpaid Preferred Return	Investment A and B - Current Income	Investment A - Disposition Proceeds	Investment B - Disposition Proceeds
Year 1				
Investor - Return of Capital		N/A		
Investor - Preferred Return	$ 2,000,000.00	$ 2,000,000.00		
Manager - Catch Up		$ 500,000.00		
Investor - 80% of Residual		$ 160,000.00		
Manager - 20% of Residual		$ 40,000.00		
Year 2				
Investor - Return of Capital		N/A		
Investor - Preferred Return	$ 1,840,000.00	$ 1,840,000.00		
Manager - Catch Up		$ 410,000.00		
Investor - 80% of Residual		$ -		
Manager - 20% of Residual		$ -		
Year 3				
Investor - Return of Capital		N/A	$ 7,900,000.00	
Investor - Preferred Return	$ 2,000,000.00	$ 2,000,000.00	$ -	
Manager - Catch Up		$ 450,000.00	$ -	
Investor - 80% of Residual		$ -	$ -	
Manager - 20% of Residual		$ -	$ -	
Year 4				
Make-Up for Realized Losses		$ 2,000,000.00		$ 100,000.00
Investor - Return of Capital		$ -		$ 15,000,000.00
Investor - Preferred Return	$ 2,168,000.00	$ -		$ 2,168,000.00
Manager - Catch Up		$ -		$ 642,000.00
Investor - 80% of Residual		$ -		$ 5,672,000.00
Manager - 20% of Residual		$ -		$ 1,418,000.00
Total Distributions to Investor	$ 38,840,000.00			
Total Distributions to Manager	$ 3,460,000.00			

This variation represents a compromise between the ''whole deal'' and ''preferred return only'' income source variations. It delays the distribution of carried interest with respect to current income (relative to the ''preferred return only'' variation), as the required preferred return amount will generally be higher, yet permits payment of carried interest on current income before any invested capital has been returned as a result of realizing investments (unlike the ''whole deal'' variation).[13]

Considerations

From a time value of money perspective, the increased deferral of carried interest entailed by a whole fund model (or those versions of the deal by deal model that defer carried interest more than others) is better for investors and worse for managers. In addition, investors generally cannot know with certainty that their investment in a fund will be profitable until they have received-at the very least-their capital contributions; and they do not know with certainty the ultimate level of profitability of a fund until the fund is liquidated and wound up. A whole fund model mitigates investor concern with earlier distributions of profits to managers because investors will recoup the whole of their capital contribution-plus some preferred return thereon-before the manager receives any distributions of profits on account of the manager's carried interest.[14] Those versions of a deal by deal model that defer carried interest more than others accomplish a similar investor goal by holding the manager more immediately accountable for later losses or less impressive performance. In practice, a large number of real estate private funds follow the whole fund model,[15] likely as a result of these well understood investor considerations.

Despite these investor advantages, the whole fund model can dampen the intended incentive effects of carried interest for managers for the very same reason that it benefits investors from a time value of money perspective—significant profits from prior realized deals are deferred, sometimes for significant periods of time. This is particularly troubling for savvy fund managers who seek to reward individual investment professionals for the performance of specific investments they had a hand in sourcing or closing and to align the interests of younger employees with more senior principals. Many younger employees have a shorter frame of reference than more senior principals. If carried interest is distributed on a whole fund basis, younger employees may not assume that they will be

employed by the manager for the entire (often lengthy) period necessary for them to enjoy the benefit of such carried interest. Thus, even when these employees play a lead role in making investments that are sold for significant profits prior to their departure, they may not expect to be rewarded for such performance (with any rewards not given to them distributed to other, presumably more senior, employees or principals). In comparison, if carried interest is distributed on some type of a deal by deal basis then managers can more easily reward the successful performance of individual employees (including junior employees) and principals, and profits realized in relation to particular investments can be distributed to the individuals most responsible for those investments as and when those profits are actually realized.[16]

The incentive effects of a basic whole fund model can also vary depending upon whether a fund's investments generate more or less current income. For example, the basic whole fund model may not have a desirable effect on the incentives of a manager of a value-add focused fund,[17] where an important goal is increasing investment cash flow on multiple investments at the same time. A manager operating under a basic whole fund model will have an increased incentive (relative to an income source variation of the whole fund model or a deal by deal model) to focus its attention fully on one or more investments early in the life of the fund and delay the draw-down of additional capital (including for capital investments made to improve long-term current income performance) so that once those initial investments have been sold, the manager is able to receive carried interest distributions. This is due to the fact that even though the whole fund model requires a full return of all capital (plus a preferred return thereon) prior to any carried interest distributions, the fund must only return capital (plus preferred return) contributed as of the time of any distribution. In the most extreme scenario,[18] a manager would purchase a single asset and cause the fund to sell it and distribute all proceeds prior to purchasing any other assets. In contrast, under a deal by deal model (or an income source variation of the whole fund model), a manager can receive carried interest distributions with respect to one or more investments prior to returning all contributed capital as of the date of any distribution (and potentially even prior to any sales of investments).

On the other hand, the more pro-manager versions of the deal by deal, realized loss model waterfall may be objectionable to investors in funds generating significant income (including value-add funds) for similar reasons. For example, such a fund utilizing the preferred return only variation on the deal by deal model waterfall described above may have one investment which performs extremely well, yielding strong increases in current income, and a second investment which breaks even or generates middling performance (as in the example shown in Figure 4.2). For the first investment, the manager is rewarded with early carried interest distributions from the robust current income stream, and due to the increased operational cash flow, the value of the investment upon disposition likely also increases, allowing for a full return of capital to investors. For the second investment, although the manager is unsuccessful in fulfilling its investment mandate, such manager need not account for the poor performance until realization. This delayed accountability for a poor current income yield on specific investments may lead a manager to hold poorly performing investments longer than consistent with the fund's risk profile in an attempt to turn those investments around, avoid realizing losses, or both. The ''hybrid'' current income version of the deal by deal model waterfall described above addresses such investor concerns to some extent by permitting manager carried interest on current income only if distributions to investors exceed a preferred return target that is calculated with respect to all of the fund's investments.

Conclusion

One of the advantages of investing in a private fund is that the parties can carefully tailor the manager's incentive profit-sharing arrangements or so-called carried interest to a fund's particular investment strategies and to a manager's desired goals. Investors and managers alike should carefully consider the numerous possible variations in crafting such arrangements to ensure that their interests are appropriately aligned and that they are properly compensated for their respective contributions, whether of expertise or capital.

---

[1] Throughout this article, the term ''fund'' means an entity that will invest in multiple real estate assets over an extended time period, whether a traditional real estate private fund, programmatic joint venture or similar entity; the term ''manager'' means the active manager, managing member, general partner or other managing entity of a fund that is entitled to receive the carried interest or promote distributions based on the financial performance of the fund's investments; and the term ''investor'' means the limited partners, non-managing members, investor members or other non-controlling equity owners of a fund.

[2] The term ''carried interest'' is used exclusively throughout the remainder of this article instead of the term ''promote.''

[3] In addition to carried interest, a manager (or its affiliated operating companies) is often entitled to receive more certain compensation in the form of various fees, such as an investment or asset management fee, acquisition fees, financing fees, development management, or property management fees. A manager also commonly invests a certain amount of equity into the fund it manages alongside other investors and is entitled to returns on and of that equity investment on generally the same terms as other investors. For simplicity, this article ignores these forms of manager compensation and investment returns and focuses exclusively on the manager's carried interest. Of course, when analyzing the overall incen-

tives of a manager, these other forms of compensation and investment returns may have incentive effects that are not completely correlated with-if not directly contradictory to-the incentive effects of the manager's carried interest.

[4] Preferred return and carried interest percentages are often influenced by the same factors affecting the choice between ''whole fund'' versus ''deal by deal'' carried interest. For simplicity, this article assumes (a) the same investor preferred return/overall manager carried interest percentages for all examples and (b) that the fund distribution waterfall used in all examples, except where specifically noted, returns capital first and then preferred return (rather than first paying preferred return and then capital). In addition, this article assumes that investor preferred returns are calculated (i) as a separate ''yield'' on contributed capital, rather than on the basis of an internal rate of return, a net asset value test, whole dollar hurdle, or some other form of investment performance measure and (ii) on a cash basis, as and when cash is actually contributed by and distributed to an investor.

[5] As a result, this article does not address the distinctions between (i) a 100 percent catch-up (sometimes referred to as a ''disappearing'' preferred return or ''quickly disappearing'' preferred return (to distinguish it from the following item (iii)), (ii) waterfalls without such ''catch-up'' distributions (also known as a ''permanent'' preferred return), and (iii) the intermediate range of ''graduated'' catch-up possibilities.

[6] Most readers are likely familiar with the concept of a ''claw-back'' which provides, often at the liquidation of the fund, that if the manager has received carried interest and either (a) the investors have not received their specified preferred return on their total contributions to the fund through that point in time or (b) the total carried interest paid to the manager to that point in time exceeds 20 percent of the aggregate profits of the fund, the manager will pay to the investors the greater of (i) the amount of carried interest the manager has received in excess of 20 percent of the aggregate profits of the fund or (ii) the amount required to provide the investors their preferred return, but usually, with respect to amounts provided in both (i) and (ii), never in excess of the aggregate amount of carried interest the manager has actually received, net of taxes the manager has paid on such carried interest.

[7] There are some important additional complexities to note in the use of this variation (or other types of income source variations) that arise from the potential combination or netting of different tiers of the two distribution waterfalls to avoid the duplication of certain distributions and other unintended results. First, distributions made with respect to the preferred return tier of both waterfalls can be combined so that the total preferred return distributions are not duplicated. Second, the catch up portions of both waterfalls may be combined to cap the catch up distributions to the manager at the carried interest percentage of total profits of the fund to avoid duplication or over-distribution of carried interest. Third, if the disposition proceeds and current income waterfalls are not completely separate and distribution of profits under the disposition waterfall count towards paying the preferred return under the current income waterfall, then the order in which the distributions are made can result in different amounts being distributed to the manager at different times. Finally, the claw-back should be clear that it functions on an aggregate basis for both waterfalls with respect to all fund profits at liquidation.

[8] Of course, this assumes that there is no claw-back (which is probably a good assumption for this model if it is employed).

[9] Again, ignoring any incentive effect resulting from any capital invested by the manager.

[10] In the authors' experience, the strict deal by deal model is encountered, if at all, only in programmatic joint ventures where the investor retains significant rights in approving individual transactions.

[11] It is important to note that a ''realized loss'' need not be limited to the sale of an investment at a loss, but could include other measures of impairment of an investment's value. For example, it is common to treat any permanent write-downs of a fund's investments (as reflected in a fund's audited annual reports) as ''realized losses'' for purposes of the distribution waterfall.

[12] Note that, as a practical matter, a manager would be unlikely to receive any carried interest out of current income distributions under this variation.

[13] For this reason, it is even more important in this model to pay careful attention to the timing of distributions and other considerations referenced in Footnote 7.

[14] See Schell, James M. Private Equity Funds: Business Structure and Operations. New York: Law Journal Press, 2008, pp. 2-21, on the history of the deal-by-deal versus whole fund model in the leveraged buyout fund context, where some form of deal by deal model is more common. It should be noted that while the whole fund model reduces the need for a claw-back feature, it does not eliminate it entirely if commitments to the fund are drawn down over time and the funding of some commitments occurs later in a fund's life after earlier contributions have been returned and the manager has taken some carried interest. As a result, a claw-back is often still requested for funds with a whole fund model distribution waterfall. It should also be noted that a claw-back provision, in and of itself, should never be viewed as either a necessary or a sufficient condition to ensure the appropriate distribution of profits between investors and a manager as (i) various types of provisions can always be incorporated to defer carried interest even further (such as requiring achievement of some NAV or whole dollar return test before permitting the distribution of carried interest), which end up serving the same purpose (and are not that different than the more investor-friendly waterfalls discussed in this article) and (ii) other measures are usually required to actually give the claw back ''teeth,'' such as personal guarantees of the claw-back by a fund's investment professionals or a credit worthy investment firm, escrowing at least some portion of the manager's carried interest, interim testing of the claw-back or some combination thereof.

[15] See The 2008 Preqin Private Equity Real Estate Review. London: Preqin Ltd., 2008, p. 106, stating that of funds sampled, 82 percent used a whole fund model distribution waterfall.

[16] While a manager can of course still internally track and attempt to reward individual performance where carried interest is paid on a whole fund basis, the ultimate distribution of any carried interest actually paid is always deferred. It should also be noted that there are a variety of complex issues (which this article does not address) associated with attempting to reward individual performance in the manner described here, even when carried interest is distributed pur-

suant to a deal by deal model waterfall. This is largely due to the fact that in most versions of such deal by deal waterfalls, the performance of one investment can affect the carried interest paid with respect to other investments (e.g. where re- alized losses must be made up prior to payment of any car- ried interest on future deals) and different individuals may be responsible for different investments.

[17] A ‘‘value-add focused’’ fund generally means a fund with an investment strategy of purchasing underperforming properties and increasing their value through leasing exper- tise, rehabilitation or additional construction, changes in use, more efficient management or some other property-level, operational expertise.

[18] Although this particular scenario is extremely unlikely given the limiting effect of a fund’s investment period, the principal it illustrates still applies in normal circumstances for most funds using the whole fund model.

Appendix 2. Predicting the Collapse of Real Estate Markets

The warning signs

Neil Osborne MBA

Bernard Baruch outlines in his book “My Own Story” published by Henry Bolt and Company, a philosophy which guided him in predicting major collapses in the stock market. Bernard Baruch was a successful financier who made a fortune on the stock market, and was one of the few wealthy stock players that predicted the 1929 stock market collapse, and totally liquidated his holdings prior to the collapse. Baruch’s guiding philosophy was developed from a text published in 1841 by Charles Mackay LLD, with the intriguing title called “Extraordinary Popular Delusions and The Madness of Crowds”, which is a study of mass manias, crowd behavior, and human folly. The book encompasses a broad range of scams, manias and deceptions, including witch burning and the Great Crusades. It also includes real estate frenzies such as the Mississippi Bubble. Both these books offer insight into crowd behavior and provide approaches, which are helpful in predicting the “boom” and subsequent “bust” of real estate and stock markets.

Through studying the psychology of crowd behavior, Baruch was able to identify certain factors which help guide him in his investment strategies. In his book, he states “anyone taken as an individual is tolerably sensible and reasonable - as a member of a crowd; he at once becomes a blockhead.” Runs on banks, lynch mobs, wild increases in real estate markets, and subsequent collapses, are examples of crowd behavior in action.

Some of Baruch’s observations, adapted to real estate markets by the author, are:

a) It is not an event which is important, e.g., rapidly increasing mortgage rates, but how people react to the event that is important.

b) Over the long run, the law of supply and demand will prevail, i.e., as prices rise, production will increase, consumption will eventually decrease and prices will fall. If prices fall, production will decrease due to losses, and consumption will increase. Often there are short term distortions which cause us to lose sight of this basic premise.

c) If things don’t make economic sense, watch out, or “two plus two equals four”. This statement appears simple but can offer insight into understanding why real estate prices sometimes rise, and then fall rapidly.

When real estate or stocks are selling for prices that make little economic sense, there will likely be an eventual collapse. Often these prices are based on totally unreasonable predictions of future values for rents, selling prices, etc.

As an example, during the late 70’s, the prices of condominium sites were bid up by developers who expected to sell the condominium units at extremely high prices, which some did? At the same time interest rates were extremely high, but purchasers’ combined salaries had not changed all that much. If this situation is examined in clear, cold, economic terms, the situation did not make economic sense. Eventually, the market collapsed, bankrupting many builders and seriously damaging the real estate sales market.

In summary, if things don’t make economic sense, watch out.

d) Frenzy increases in market prices usually occur when fringe players enter the market. Some stock market investors believe that when the general public becomes heavily involved in the market, its time to get out. The 1978/82 boom and bust of the real estate market was characterized by the entry of large numbers of fringe players. Lawyers, accountants, businessmen, all got involved in developing real estate, while some of the developers who had been in the business for many years, wisely withdrew from the market.

e) Another sign is a significant increase in sales of real estate by quickly flipping the ownership from one investor to another. During “boom and bust” cycles, it is not uncommon to see a development site change hands six or seven times, each time selling for a higher price. The final owner being caught with the property, which suddenly dropped in value below the price which was paid. Those that developed the properties found that they couldn’t sell the units at the originally predicted prices because consumers couldn’t arrange financing, or simply weren’t’ prepared to pay these very high prices, and the developer went into receivership, or sold the units at a considerable loss.

f) When young professionals who haven’t paid their dues start making obscene amounts of money in boom times, watch out. It won’t last over the long term.

The above review of Baruch’s investment philosophy, which has been adapted to real estate markets by the author, provides a guideline for recognizing potential market collapses. Realtors have to take advantage of boom times, but also be prepared for the subsequent bust. Frenzy markets simply do not go on forever, so look for the warning signs.

References:

My Own Story. Barnard Baruch. Publisher: Henry Bolt

Extraordinary Popular Delusions and the Madness of Crowds
Charles Mackay. Paperback

Financial Illusions. Kenneth Galbraith. Paperback

Movie; Wall Street