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9-208-066

REV: MARCH 23, 2009

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Structuring Real Estate Deals: An Investor's Perspective

Every investment requires the same set of questions:

I. What are the portfolio-level implications?
II. What are the asset-level characteristics?
III. How do I invest?
IV. How much do I invest?
V. With whom do I invest?
VI. What do I get for my investment?
VII. What protections do I have?
VIII. When and how do I get out?

This note discusses each of these questions in detail from the perspective of a potential investor.

I. What Are the Portfolio-level Implications?

Investors should view potential real estate investments in relation to their ideal total portfolio. Real estate investments are available over a wide array of public, private, domestic, and foreign assets. There are opportunities to invest directly in real estate with a private counterparty. Alternatively, one can invest via indirect instruments with real estate as underlying collateral. These range from synthetic instruments, indices, mortgage-backed securities (MBSs), residential mortgage-backed securities (RMBSs), collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), real estate investment trusts (REITs), and mortgage REITs, to mortgages, operating companies, and real estate funds. This note assumes that investors will first research the performance of a real estate investment and its potential correlation with their total portfolio. This note also simplifies the common points on deal structuring that arise in any negotiated private agreement.

Professor Arthur I Segel prepared this note as the basis for class discussion with the assistance of Research Associates Aniq Kassam and Ben Creo. The author wishes to thank Samuel Plimpton and HBS Lecturers Charles F. Wu, Nori Lietz, and John D. Macomber for contributing industry insights.

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II. What Are the Asset-level Characteristics?

Experienced real estate investors often argue that most of the profit in real estate transactions is determined at purchase. Thus, an investor's best protection is an advantageous entry price point, as well as resistance to outlandish projections. The essential analysis of risk and return—what can I lose versus what do I make?—must be conducted at the asset level. This analysis must be tested with appropriate sensitivity analyses to assess the risk and potential volatility of returns on a leveraged and unleveraged basis. Specifically, what happens in a TWGTH ("The World Goes To Hell") scenario? Constant awareness of downside scenarios is imperative to ensuring that the appropriate margin of safety is in place. The investment should also be assessed for unexpected correlations with other portfolio positions (for example, a leaseback to a portfolio company, or a land investment in a market where a portfolio company home builder has a large commitment, etc). Lastly, once the investment structure is determined, the investor needs to assess the after-tax, post-currency, post-transaction friction, net cash flow results, and sensitivities. Assuming that the investment has met initial portfolio and asset-level analytical demands, the real work begins. The due diligence confirmation process should interact with the financial analysis; investor legal and technical questions arising from due diligence should be used to better understand the key drivers and sensitivity variables in the financial analysis.

III. How Do I Invest?

Once the investor has determined that the economics are acceptable, the question of how to structure an investment can be addressed with the counterparty. Real estate deal structuring is about identifying and mitigating risk; thus, it is crucial to surround oneself with knowledgeable experts for legal, market, and technical due diligence. The rules and commercial practices differ from one political jurisdiction to another. For example, while there is a uniform commercial code in the United States, laws about limited partnerships and credit may be slightly different in each state. Further, construction practices, market requirements, and the structure of economic terms with end-users of real estate investments (tenants, buyers, etc.) vary greatly between venues. For example, investing in Chinese apartments necessitates a different expertise than investing in French farmland. Finally, understanding the specific needs and risks of the local counterparty in the deal is critical to balancing and aligning the competing interests of investor and counterparty.

How an investor invests also depends on the investor's risk tolerance, domicile, tax status, the country they wish to invest in, and the tax laws/treaties applicable to the various jurisdictions the investment is being routed through. Thus, it is invaluable for the investor and the counterparty to obtain help from lawyers and accountants who best understand different forms of legal ownership[1] and the consequent tax implications.[2] An institutional investor from Europe is subject to a different tax environment (FIRPTA-Foreign Investment Real Property Tax Act) than an institutional investor in the United States. An institutional investor in the U.S. may, for reasons pertaining to UBTI (Unrelated Business Taxable Income), want to make an investment in a certain corporate form such as a REIT, while an individual investor may want a limited partnership vehicle. In addition, the counterparty may have very different tax exposures, which need to be addressed.

[1] See "Note on Forms of Real Estate Ownership," HBS No. 373-148.

[2] See "Note on Taxation [of Real Estate]," HBS No. 379-192.

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All investors, especially if they are "passive,"[3] want to limit their liability to the maximum extent possible with regard to the identified risks. Under U.S. tax code, so-called "active" investors also have the option to match losses and gains for tax purposes among different properties. Each investor (and counterparty) needs to evaluate their interest on a "landed" (that is, a venue of the investor or counterparty) basis, net of all the taxes, entity costs, transaction costs, and currency adjustments.

IV. How Much Do I Invest?

Again, the particular nature of the investor's portfolio and the characteristics of the assets determine the answer. Issues include (a) what is the investor's capacity, (b) how much diversification do they want within the asset class, (c) how much risk can they tolerate, and (d) what are the characteristics of the subject investment? While one concentrated investment may lead to enormous failure, it may also create enormous wealth. As Mark Twain once said, "Put all your eggs in one basket—and WATCH THAT BASKET."

Furthermore, from the counterparty's perspective, there are issues of control. How much control the counterparty is willing to allow the investor may influence the amount any investor can invest. Some counterparties and investors may want to keep it simple, with only one joint venture partner, while others may prefer to have numerous investors with limits of not more than 10% control, thereby minimizing the influence of any single investor.

V. With Whom Do I Invest?

One of the key risk factors is selecting the appropriate counterparty. Due diligence must be performed on their specific expertise in the particular investment strategy. Are they the "best in breed"? What is their reputation in the business community? Can they be trusted? Notwithstanding the structural components of the relationship, even the best documents in the world are a poor mitigant against the risk of selecting the wrong business partner.

VI. What Do I Get for My Investment?[4]

Answering this question requires a discussion of (a) the investment's term, (b) the counterparty's contribution, (c) the preferences, (d) the return of capital from the projected cash flows or from sale/refinancing events, and (e) the splits on the balance available for distribution from the projected cash flows.

(a) The Investment's Term

Every investment is for a finite or infinite life. In theory, a publicly traded company such as a REIT has an infinite life. A private investment usually has a finite life with a predetermined maturity, often with an extension period for a specified cause, usually through mutual agreement of the parties or through a vote garnering a majority or super-majority (75%+) of investor support.

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[3] Passive investors delegate responsibility for approving investments to a general partner or investment committee.

[4] The following two sections of this technical note were revised in early 2009 to incorporate additional best practices discussed in the paper: John-Austin Saviano, Cambridge Associates, "Restoring Balance to GP/LP Relationships," February 2009.

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(b) Counterparty's Contribution

Most investment deal structures have the counterparty contributing nominal equity or work product for a disproportionate amount of the returns. Most of the time the investor will invest only if the counterparty contributes capital as well. The Harvard Management Company, for example, requires a significant capital contribution from the owner, such as 10%, or some amount sufficient to represent a substantial portion of the counterparty's net worth. A partner having "skin in the game" in conjunction with clawback clauses is one of the best risk mitigation techniques. A general partner's asset contribution should be judged on a proportional rather than an absolute basis. The purpose of a substantial contribution is to align the interests of the parties. This capital contribution usually takes the form of land, cash, or a note or guarantee often collateralized with another kind of security.

Transparency in the partnership is of the utmost importance. Full disclosure is necessary of each principal's contribution and in what form it takes: cash, fee offsets, promissory notes, etc. If the capital contribution is in the form of a contributed asset, the following questions should be asked: What is the value of the asset, and how is that value determined? Is the asset at the counterparty's historic cost, a discount from market value, or at market? Finally, the investor may receive additional comfort by bundling together or cross-collateralizing their preference interest with multiple projects with the same counterparty (known as "crossings").

(c) The Preferences

Investors often require a priority or preferential return on their investment before the counterparty receives any available cash flow from operations. For example, cash flow is released only after payment of all expenses and any required debt service, local taxes, and capital expenditures (or a capital event such as a refinancing or sale in the currency of the selected venue). A preference can be structured in many ways. For example, an investor may require a predetermined return of 9% on their capital before the counterparty gets anything. The nature of the preferred return—simple hurdle or permanent—also has implications for the catch-ups (discussed later in this note). For example, a 9% return on capital can be paid in many ways, and the questions that any investor must ask include the following:

- Is the preference paid currently or only out of available cash flow, if and when it is available?
- If the preference is not paid currently, does it accrue?
- If the unpaid preference accrues, is it with an interest factor?
- If it is with an interest factor, is it paid monthly, quarterly, or annually? Is it calculated on a simple or compounding basis?

If the investor has made a cash capital contribution, the investor may also require a preference on their capital. The investor's preference may be paid senior, subordinate, or *pari passu* to the counterparty's returns. The purpose of the preference is to reward the investor for putting up the greater percentage of the total capital and to mitigate some of the risk of not receiving back the investor's capital first.

(d) Balance Available for Distribution

After any preferences are paid, the balance of the net cash flow is available for distribution in varying proportions to the investor and the counterparty. The allocations vary significantly depending on the risk and return profile of the asset, and the relative bargaining powers of the

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counterparties. For example, a counterparty putting up 35% of the capital may get 35% of the balance of the funds from cash, refinancings or sales, or they may get an amount proportionate to capital contributed. The investor who put in 65%, then, would obviously get 65%.

Frequently, the counterparty receives a disproportionate amount of the net cash flow in excess of a preference capital for their imputed or sweat equity, often referred to as "promoted interest" or simply "promote." Often, this arrangement is structured in tiers or so-called "waterfalls" after certain return hurdles have been achieved. For example, the counterparty may receive 35% for their *pari passu* actual capital in the deal, with the investor receiving 65% until a 15% pretax preference return is attained, after which the balance available for distribution is split 50%–50%. To the extent that the counterparty has control of an extremely lucrative transaction or has eliminated risk, they may demand larger promotes. Obviously, the combinations are endless.

It is critical for the investor and counterparty to agree on where (in what venue, in what currency, before/after local taxes, etc.) and how returns will be calculated. For example, is the investor's contributed capital returned first or *pari passu*? And how are the returns compounded? The legal agreements should define and detail the specifics of these calculations, and examples should be included with specific numbers to give the definitions needed clarity.

(e) Return of Capital

Again, the investor needs to know when original capital will be returned. This is known as "getting the bait back." For example, is capital returned from available cash flow first, thereby reducing the preference and accelerating any tiering of the splits available for distribution? Or is returned capital subordinated to the preference requirement, or contingent on a sale or refinancing? Similarly, if the counterparty gets a return of their capital, is it senior, *pari passu*, or subordinated to the investor's return of and/or on capital and/or a hurdle rate, preference, or internal rate of return? If the venture is not terminated and payments are made, are there reserves or holdback provisions for the counterparty in the event that the investment does not perform in the future, or if the counterparty defaults in their obligations?

VII. What Protections Do I Have?

The four primary protections for an investor are (a) the fee structure, (b) the guarantees, (c) the clawbacks and creeping equity provisions, and (d) the control provisions.

(a) Fees

There are numerous ways the counterparty can make money in a deal at the expense of the investor. Therefore, the investor must understand all of them, and the counterparty must disclose all of them. It is vital for the investor to understand all forms of the counterparty's compensation. "Compensation," the saying goes, "is everything." Over and above the distributions made to the counterparty, the counterparty may earn fees for

- Asset management
- Property management
- Credit enhancement, completion, or other guarantees
- Leasing
- Project management

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- Development
- General contracting/construction
- Financing, or sale transaction
- Overhead and administration

Any of these fees (and others) may be appropriate. In all events, they should be scrutinized by the investor and disclosed by the counterparty. Furthermore, each of these fees should reflect market conditions for payment of comparable fees and services to third parties, and certainly should never be above market. Ideally, several of these fees should be paid based on performance tests, such as project completion.

In addition to the fees already mentioned, there may be performance or guarantee fees for factors such as a building being built on time, on budget, with the agreed level of quality or specifications, at the projected leasing schedule, and certified by an independent architect and accountant. It is crucial that the parties agree on all fees, and that they correlate all fee payments with the other terms of the deal, including returns of and on capital such as preferences and splits, as described above. For example, a counterparty may be willing to subordinate a sale (disposition) fee to an investor's preference return.

Transparency remains critical. Fees for a fund or project should be viewed in relation to the general partner's operating budget, which should be disclosed. A reporting mechanism must identify all fees, splits, and other forms of compensation. For example, a general partners' accounting of a limited partner's capital account must be clear and indicate the general partner's compensation that is included or not included in the cash flow to these accounts.

(b) Guarantees

As mentioned, there may or may not be separate fees paid to the counterparty for achieving certain performance measures, such as

- Project completion, timing relative to schedule proforma
- Project completion relative to financial proforma
- Lease-up timing relative to proforma
- Lease-up cash flow relative to proforma

The passive investor needs protections and penalty provisions allowing them to "creep" into the equity of the counterparty or remove the counterparty, if necessary, if certain performance measures are not achieved, or if the counterparty defaults in certain essential duties. Perhaps more important than any other downside protection is agreement on what happens if there is inadequate cash flow to meet operating, capital, or debt service expenses. It is vital for the investor to understand (a) the amount of leverage they have on a property, if any, (b) the terms of the leverage such as the term, rate, amortization, prepayment and default provisions, and (c) who is responsible for the difference, and how?

Real estate has historically been a cyclical business, and bankruptcies have occurred over and over when owners were undercapitalized and overextended, either through lack of tenant demand at prescribed rents or through being overfinanced. Any investor must understand how debt is being used. Different investors may have different objectives. Some institutional investors cannot legally employ debt. Others want as much debt as possible. Some individuals may want to employ debt because of the tax sheltering facilitated by the current interest deductions permissible under U.S. tax code.

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Investors need to understand their downside and what the counterparty can do if things go badly. Will there be a call for additional capital on a *pari passu* or some other basis? Will the counterparty make loans to the partnership? If so, at what rate and on what terms? Does the investor have the right to approve a capital event such as a loan, refinancing, or sale? Under what conditions can the counterparty identify other sources of debt or equity and dilute out the investor, or even itself? Most institutional investors seek to employ modest levels of leverage, which in today's market is 50%–66% of loan to value. Opportunistic investors may employ 80%, 90%, or more with mezzanine instruments. Market collapses reveal the corollary. In 1988, modest levels of leverage were 70% and below. But office buildings in many markets lost over 80% of their debt value (and all of their equity) over the subsequent three years. Constant focus on the downside is the key to long-term investment success.

(c) Clawbacks, Creeping Equity, and Catch-ups

The investor may have a provision to creep into the counterparty's equity should the counterparty fail to achieve certain goals of the partnership, or should they default under the terms of the agreement. For example, if the counterparty fails to achieve lease-up at the proforma rent and expense levels, the investor may have certain rights to increase their equity at the expense of the counterparty or creep into the counterparty's equity. Usually, this exchange is done by formula and in stages and can be considered on both a pre- or post-tax basis. Often investors want an investment to have continuous life and not face a sale, for the terminal benefit of both partners. There may be a so-called "true up" mechanism every five years based on some third-party fair market value process.

A fair market value process could be the so-called "three appraiser method" where both the investor and the counterparty each select an appraiser from a pre-agreed list of qualified appraisers, and the two appraisers agree on a third to arrive at a value. There are numerous ways to structure this process, and certain investments require appraisers with specific skills and expertise. Sometimes, if the two appraisers cannot reach agreement on a value, a third appraiser is then brought in. Thereafter, the highest two estimates, the lowest two estimates, the average estimate, the mean, the median, or some other defined method is used to ascertain an independent valuation.

The goal of all such appraisals (and buy-sell) arrangements should be to drive values to a fair middle ground, and to avoid avenues for gaming the process due to information asymmetries or differing financial capacities between investor and counterparty. In certain instances, there may be an investment that has done well in the first period but poorly in the next, or where the counterparty has been overpaid in the first period while the investor is underpaid in the next. For this reason, there may be a "clawback" mechanism where the counterparty must contribute back into the partnership the funds they have already received. These funds may be secured by an escrow from the previous distributions or guarantees, or from a "creeping equity provision" on the counterparty's share. Investors should ask that an escrow account maintain part of the general partner's paid carry until the initial capital investment is returned. The owner needs to know under what conditions, if any, the investor can terminate the counterparty, or step into the counterparty's equity position for failure to perform, gross negligence, or fraud.

(d) Control Provisions

Substantial investors, or a super majority vote, should seek approval rights over critical decisions for an investment. These typically include the approval of business plans or changes to a plan, material budget variances, major leases, and sale or refinancing transactions. Investors should ask for a "key persons" provision. Laws vary with the locale, but the provisions must at least have certain

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behaviors clearly defined as acceptable or not and need to apply to a suitably small group. Provisions should stipulate what happens in the event of a violation, what other investment activities or funds the general partners may pursue concurrently, and to what extent key personnel can work on other projects.

VIII. When and How Do I Get Out?

Most investments have predetermined term limits, and a sale is at the discretion of the counterparty (unless, as noted, specific conditions are not met such as building completion, lease-up according to the proforma, gross negligence or outright fraud, or in the event the investor has obtained approval rights). The counterparty may have different goals than the investor as to exit timing. For example, a counterparty may value the fee stream as opposed to realization on a marginal deal.

The investor's understanding of the exit mechanism is as important as their understanding of the downside risks inherent in any deal, and the options for structuring around them. Good investors know their exit strategy before any investment is made.

Exit mechanisms come in many forms. Some investors and counterparties use a forced sale to an independent third party or a buy-sell between the parties. Buy-sells come in many forms. A few of the more prevalent include the following:

- The investor may put their interest to the counterparty at fair market value (FMV) using the three-appraiser method, or a predetermined formula such as a capitalization rate on cash flow.
- Either the investor or the counterparty can "put" their interest to the other at any point in time after the fifth year, or at set points such as at 3/5/7 years.
- The counterparty can "call" the investor's interest at a pre-agreed premium.
- The investor can put their interest to the counterparty, and should the counterparty choose not to buy, an automatic sale to a third party is triggered.
- There is mutual agreement (by contract) to refinance after a certain point in time in order to return capital.
- There is mutual agreement (by contract) to go public at a specified time.

The investor must think about the exit mechanism while making the investment, since it is critical to structuring the investment properly. Investors use multiple securities or instruments—for example, common shares, preference shares, convertible/non-convertible debentures, shareholder loans, etc.—depending on the kind of exit foreseen. Exits or returns could be in the form of dividend distributions, sale of shares, interest payments on debentures, refinancing, or all of the above. Investors should also take into account company laws and tax laws across investment jurisdictions to ensure the most efficient and frictionless structure for both investor and counterparty.

Exit strategies depend on the investor's objectives. Some institutional investors prefer never to sell, since transaction costs are so high. These groups may need to make periodic incentive fees to the counterparty to keep their interests aligned. Some individuals may want to defer a taxable event and exit through a refinancing, which is not considered a taxable event under U.S. tax code. Other

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investors may want to maximize their returns before or after leveraging internal rates of return (IRRs), particularly after a lease renewal or retenanting at higher rental rates. Some investors may be even more interested in maximizing the payoff multiple on their invested capital, without regard to IRR. Exit strategies need to match the asset characteristics and investor, and investors need to define their objectives from the outset.

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These are the universal baseline questions that an investor must ask when structuring a deal. The following checklists provide a summary of these questions.

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Appendix

Structuring Real Estate Deals: An Investor's Perspective

I. What are portfolio-level implications?

1. How does this investment correlate with a portfolio?

II. What are asset-level characteristics?

1. What are the risk/return characteristics?
2. What are the key risk/return sensitivities?
3. Is the due diligence plan and team focused on the key risks and performance drivers?

III. How do I invest?

1. What is the appropriate form of legal ownership?
2. What is the most tax-efficient legal structure?
3. Are my interests aligned with my counterparty's?

IV. How much do I invest?

1. What is my financial capacity?
2. How much diversification do I want in my portfolio?
3. What is my risk tolerance for this investment?

V. With whom do I invest?

1. Best of breed?
2. Reputation?
3. Trust?

VI. What do I get for my investment?

1. What is the term of the investment?
2. What are the provisions for term extensions?
3. What is the counterparty contributing, and in what form?
4. If the contribution from the owner is land or imputed equity of some kind, how is that value determined?
5. What preference, if any, does the investor receive?
6. What happens when there is insufficient cash flow to pay the preference?
7. Are unpaid preferences not paid or accrued; and if they accrue, do they do so at a simple or compounded rate in a monthly, quarterly, or annual form?
8. Does the owner receive a preference? When and how?
9. What is the distribution formula after preferences are made? Are there any hurdles or waterfall events? How are they calculated?
10. How and when is original capital returned? Before or after the preferences? Before or after the distributions?
11. Under what conditions can the owner's share of the equity be reduced if at all?
12. Are there any clawback requirements, and how are they secured?
13. Under what conditions can the counterparty be removed?

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VII. What Protections Do I Have?

1. What exactly are the fees being paid to the counterparty—and in what form, and how?
2. Are the fees (if any) paid to the counterparty aligned with the investor's interests? Are the fee levels comparable to market?
3. Does the investor want to employ any leverage?
4. If the investor employs leverage, how much leverage is employed, and under what terms and conditions?
5. If there is a cash shortfall of any kind to pay operating expenses, capital requirements, or debt service, what can the counterparty do to recapitalize? Can the investor be diluted?
6. If the owner makes loans to the venture, under what terms, conditions, and priorities should they be made?

VIII. When and How Do I Get Out?

1. What are the investor's objectives? The counterparty's?
2. What is the term of the investment, and how does it mesh with the investor's objectives? With the counterparty's objectives?
3. How should the investment be structured, keeping in perspective contemplated methods of exit?
4. What are the obligations of the owner to liquidate the investment?
5. What, when, and how can the investor force a liquidation?

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