

Fees in Real Estate

Introduction

For the first time in a number of years conditions are falling into place for positive long-term returns from more opportunistic investment strategies in real estate, being offered by certain specialist fund managers. These so-called private equity-style real estate funds appear well placed to take advantage of continued dislocations in property markets, including distressed sales of over-leveraged portfolios or assets. However, as in other alternative asset classes, fees for these types of funds can be very high and complex. In this paper, we outline some of the main fees and terms we have come across and how we would like them to change in order to produce a fairer deal for investors. We note there is significant variation in typical fee structures in Australian opportunistic real estate and we highlight where this is the case.

Fees in private equity-style ('opportunistic' or 'value-add') real estate funds

Many of the value-add and opportunities in real estate funds that we research are structured along the lines of private equity-type vehicles with fee scales to match. Some of the features of these fee scales include:

- Fees based on commitments rather than invested capital—this is a standard approach in the US, Europe and Asia, although in Australia most funds charge fees based only on invested capital.
- In other cases, fees based on gross asset value rather than net asset value.
- High management fees of 1-2 per cent per annum.
- Preferred return structures for the payment of performance fees, of around 8 per cent p.a., although sometimes higher.
- Performance fee share of 20 per cent (with potential for it to be paid partly in cash and partly in units of the underlying fund with a suitable lock-in period, for older funds with periodic payment structures).
- 'Catch-up', where the manager takes a proportion of the fund returns (over and above the preferred return) until it receives its target profit share. This may be taken before the investor receives any of its share of the profit or be phased over time. In Australia, opportunistic funds typically have a genuine hurdle (i.e. no catch up) of 13-15% p.a. with a higher performance fee share of 30% or more.
- Additional fees and charges in some cases, for example, transaction, development or financing fees, fund expenses and so on.
- Deal by deal payment of performance fees (with capital invested in individual assets returned) as opposed to prioritising the return of all capital first.

Naturally, individual funds structure their fees in different ways and may not include all of the above. In summary, we have reservations about a number of these features.

Fees on commitments

The rationale for fees on commitments stemmed from the days when the industry was immature. A firm raising its first fund needs to have reliable income from day one to remain in business. In addition, some managers argue that charging fees on invested capital would encourage the manager to invest too quickly. However, very few real estate funds are raised by managers who are new to the business and need the steady income to remain in business.

Fees on commitments generate a large part of the 'j-curve' or fee drag of investing in real estate and clients do not like to pay fees on uninvested cash. A well-constructed performance fee should alleviate the risk of putting money to work too quickly and in unprofitable deals.

Therefore, unless there are very strong reasons to the contrary, Towers Watson would prefer to see real estate fund fees charged on invested equity capital as opposed to committed although we accept that fees may be charged on commitments during the investment period, especially for newer groups.

Fees based on gross asset value versus net asset value

Many management fee structures have been calculated on gross asset value, taking into account a fund's total size including its debt exposure. Such a fee basis may encourage managers to use gearing when it may not be most beneficial for the fund, which clearly represents a potential conflict of interest. We believe that fees should be based on equity capital invested. Other funds will charge fees on net asset value, which reduces the issue of rewarding a manager purely for taking on debt. However, such an approach ends up rewarding managers for market-related valuation increases, not only for value added through skill.

Towers Watson would prefer to see management fees calculated based ideally upon equity capital and, failing that, on net asset value but not on gross asset value.

High management fees

Fee levels for more specialised vehicles tend to be in the region of 1-2 per cent per annum. Whilst we would expect modest management fees given that even tracking the real estate market requires a degree of 'active' management, fees which are over 1.5 per cent have the potential to negate any underlying outperformance over the market average in all but the most opportunistic strategies. Our belief is that management fees should just cover the cost of running the fund on a day-to-day basis and should not contain a significant element of profit particularly where there is a profit-sharing mechanism in place.

Towers Watson would prefer to see management fees which reflect the budgeted costs of running the real estate fund.

Preferred return, hurdle rates and catch-up provisions

Not all real estate funds appear to have adopted the same hurdle rate as private equity (often 8 per cent). In our view, the preferred return/hurdle rate should reflect the long-term return for the real estate market as a whole (adjusted for any inherent leverage) so that the manager only earns a performance fee for added value. Preferred returns/hurdle rates should be calculated with reference to the nature of the underlying fund and its relationship to market average, for example a property index or risk-free rate plus a margin.

Towers Watson believes that a lot more thought should go into the setting of a preferred return/hurdle rate that reflects the particular strategy being followed and should ensure that the manager only earns a performance fee if it is generating real outperformance in excess of the market (net of its management fee after adjusting for risk).

A well-designed performance fee should reward added value not just returning the market average return. Catch-up provisions¹, whether phased in or paid up front, reward both.

Towers Watson believes that in real estate, there should not be any catch-up and that carried interest should only be payable on excess returns above a hard hurdle (taking into account management fees) and not on total returns.

In the event that a catch-up mechanism does exist, it should be appropriately structured and weighted in favour of the investors.

Carried interest

The carried interest proportion (or performance fee share), which is typically 20 per cent, is probably not unreasonable if the hurdle and catch-up provision are properly designed. However, we see a number of fee arrangements where the carry does not go to the investment teams which we do not believe aligns interest well.

We believe that a high proportion of the carried interest should go to the team running the fund rather than to the parent organisation.

In addition, we see funds falling into two groups in terms of how and when carry is payable. In the first, carry becomes payable once the investor has received its capital back. In the second, carry is payable either on a deal by deal basis or on a periodic payment structure.

We believe that performance fee payments (calculated above the preferred return/hurdle) should only be paid once capital plus fees have been returned to investors. Periodic payments might be acceptable for open-ended funds, but these ideally should be calculated on a rolling period basis.

Where periodic performance fees are acceptable, there should be a suitable claw-back mechanism in place with appropriate safeguards (such as placing an appropriate percentage of any fee in an escrow account) to protect investors.

In Australia, many funds have higher performance fee rates but link these to a much higher hurdle rate that more closely proxies the actual net return being targeted by the manager, for instance 30% of all returns in excess of a 14% hard hurdle rate. We believe this can present a stronger alignment.

¹ Whereby once the preferred return has been achieved, the manager looks to recoup its share of the overall return achieved rather than just its share of excess returns over and above a hard hurdle.

Additional fees and charges

Some real estate funds make additional charges. This is particularly the case for specialist vehicles that follow defined strategies such as 'opportunity', 'opportunistic' or 'value-add' funds. Some are reasonable and relate to the establishment of the fund (although they should always be justifiable), auditing the fund, valuation and so on, and do not benefit the manager. In other cases, the fees are not justified, for example, transaction fees for undertaking the project management of a refurbishment/development and so on, or financing fees. Whilst these have been the traditional practice for a large number of real estate funds, we do not believe they are justifiable as the services provided should be part of an appropriately skilful manager's 'tool box' and covered by the management fee. Should a manager not be able to provide these services 'in house', it may attempt to instruct third parties and recharge the cost. In this case the manager's skills should be carefully examined against the strategy of the fund and the level of the management fee.

Towers Watson's view is that the fund manager should not make incremental charges like transaction, development/project management or financing fees. This work should be covered by the management fee.

In some cases, there will be related-party fees, for example, advisory fees or property management fees charged by other divisions within the fund manager's organisation. These charges would be payable whether or not the fund manager uses its sister company for the advisory work. Such fees should be considered very carefully against the quality of the in-house service being provided compared with using external professionals and the level of fees being charged. The key consideration should be value for money.

Towers Watson's view is that advisory and other fees payable to a related entity should be transparent. A fee scale and the scope of the instruction should be agreed in advance so that benchmarking can be conducted and the actual fees paid should be communicated to both investors and prospective investors on a regular basis.

Summary

We are positive about the strategic case for 'opportunistic' real estate investing as part of a diversified real estate asset strategy for long-term investors with good governance. Unfortunately, the fee arrangements make us much less positive on backing many of the non-Australian funds that are actually available for clients to invest in. We believe it is important to take a 'fund-by-fund' approach to negotiating fees as each situation will be different. However, we must reiterate that certain practices in the real estate industry around terms and fees need to change. For this reason, we believe it is quite natural for Australian investors to have a bias to one or more high quality local managers, albeit they may wish to establish some global or regional diversification if a suitably well-aligned offshore fund can be identified. We qualify this by noting that we believe there are very few fund managers that present both very strong capabilities as well as well-aligned product and fee structures.

About Towers Watson

Towers Watson is a leading global professional services company that helps organisations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Contact

For further information please contact your Towers Watson Consultant or Actuary:

Melbourne	03 9655 5222
Sydney	02 9253 3333

The information in this publication is general information only and does not take into account your particular objectives, financial circumstances or needs. It is not personal advice. You should consider obtaining professional advice about your particular circumstances before making any financial or investment decisions based on the information contained in this document.

Watson Wyatt Australia Pty Ltd, a Towers Watson company
ABN 45 002 415 349 AFSL 229921

Copyright © 2010 Towers Watson. All rights reserved. Published April 2010

towerswatson.com

TOWERS WATSON 