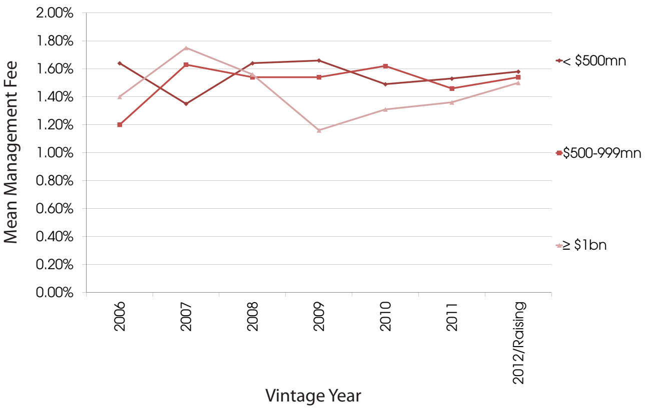
Real Estate Fund Terms and Conditions: Balance of Power Shifting?

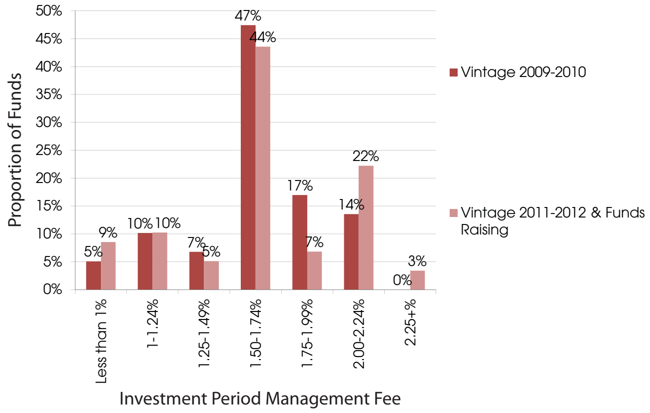
Fund terms remain a key issue that investors will look at when examining potential commitments. Drawing on data from the 2012 Preqin Private Equity Fund Terms Advisor publication, Sarah Unsworth examines how the fees charged by real estate funds are changing.

Fig. 1: Real Estate Mean Management Fee by Fund Size and Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

Fig. 2: Real Estate Management Fee during Investment Period



Source: 2012 Preqin Private Equity Fund Terms Advisor

As fundraising for private real estate funds became more challenging in the wake of the financial crisis, it appeared that there was a shift in certain areas of fund terms and conditions in favour of LPs. With the fundraising market extremely crowded and institutional investors now more demanding than ever, wider conditions have pushed many GPs towards offering potential LPs concessions in regards to fund terms and conditions. While headline fund terms and conditions became slightly more LP-friendly in 2009 and 2010, this change has now reverted somewhat among the most recent funds.

Management Fees

Institutional investors have been keen to ensure that management fees cover a GP's expenses/costs, without representing a significant source of profit. Pressure from the institutional investor community for real estate fund managers to lower management fees increased in the wake of the financial crisis; however, there has actually been little downwards movement. As can be seen in Fig. 1, management fees have remained fairly consistent, albeit with more variance by vintage year for larger funds than for smaller funds. Indeed, it appears that management fees have increased slightly for 2012 vintage funds and funds currently raising, with these funds having average management fees of 1.50% for funds of $1bn or more, 1.54% for funds of $500-900mn, and 1.58% for funds less than $500mn in size. While management fees have remained relatively consistent at an industry level, there are growing numbers of GPs that offer reduced fees for investors that commit before the first close of the fund, or similar concessions that encourage early investment. In general, changes in management fees are unlikely to be dramatic. The institutional investor community generally recognizes the need to balance between incentivizing GPs via carried interest as opposed to non-performance-related fees, and reducing such fees to the detriment of the fund. Fund managers are unlikely to drop fees below a certain level, as doing so risks damaging the day-to-day running of the fund and the potential for generating attractive future returns.

Due to the economies of scale enjoyed by GPs that manage larger funds, the management fees for such vehicles are generally somewhat lower than for the smaller funds. These larger GPs are more likely to be able to reduce management fees than those managing smaller amounts; for example the variable costs of a GP with $1bn in funds under management are unlikely to be double those of a manager with $500mn under management. Management fees have therefore become a significant source of revenue for some of the larger GPs. However, despite the criticism levelled at real estate fee levels in recent years – and particularly those charged by larger funds – the disparity between the management fees charged on funds of differing sizes seems to be narrowing. For vintage 2009 funds, the difference in the average management fee between funds of $1bn or more and those of less than $500mn in size stood at 50 basis points. For vintage 2012 funds and those still raising, however, the gap has narrowed to eight basis points.

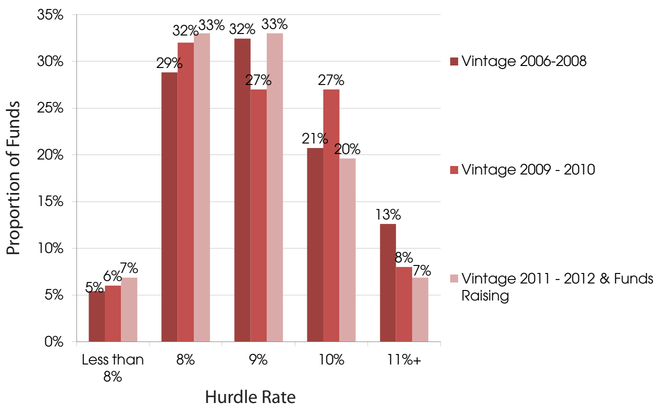
The management fee charged during the investment period is generally calculated as a percentage of the total commitments made by LPs to the fund. The rationale behind this is that the major part of a GP's workload at this stage is the search for potential investments, which is driven by the aggregate size of commitments to the fund and not the amount invested at this point in the fund's life.

Fig. 2 shows the breakdown of management fees charged during the investment period by real estate fund managers. For vintage 2011 and 2012 funds, and those currently raising capital, 44% of funds charge

Fig. 3: Real Estate Fund Mean and Median Hurdle Rate by Vintage Year

Source: 2012 Preqin Private Equity Fund Terms Advisor

Fig. 4: Real Estate Fund Hurdle Rate Distribution by Vintage Year



Source: 2012 Preqin Private Equity Fund Terms Advisor

a management fee of 1.50-1.74% during the investment period. There has been a slight shift towards higher management fees during the investment period, with 22% of funds charging a management fee of 2.00-2.24%, compared to 14% for 2009-2010 vintage funds. Additionally, 3% of 2011-2012 vintage funds and those in market have a management fee of 2.25% or more, whereas no 2009-2010 vintage funds charge this higher amount.

Hurdle Rates

While there has been some movement in management fees, there has been little variation in carried interest charges, with 85% of funds in market or with 2011-2012 vintages charging 20% carried interest. The same proportion of 2009-2010 vintage funds charge 20% carry.

Changes have occurred, however, in the hurdle rate set by private real estate fund managers, as shown in Fig. 3. Mean hurdle rates increase steadily with vintage year between 2008 and 2010, as pressure from LPs regarding performance following the financial crisis led to more investor-friendly terms. Despite this, it appears that hurdle rates are now moving back in favour of the GP, decreasing from an average of 9.3% in 2008, to an average of 8.7% for vintage 2012 funds or those currently in market.

Fig. 4 shows how real estate fund hurdle rate distribution varies by vintage year. Compared to 2006-2008 vintage funds, hurdle rates for 2009-10 vintage funds are slightly more LP-friendly. Only 8% of 2009-2010 vintage funds have hurdle rates in excess of 11%, compared to 13% of 2006-2008 vintage funds. Twenty-seven percent have a 9% hurdle rate, compared to 32% of 2006-2008 vintage funds.

Data Source:

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While there may have been a slight shift towards more LP-friendly terms, the hurdle rates for 2011-2012 vintage funds and for those currently raising suggests a shift back in favour of the fund manager. The proportion of funds with hurdle rates of 10% or more has fallen from 35% for 2009-2010 vintage funds, to 27% for more recent funds. The most common preferred return among real estate funds is 9%, with 33% of vintage 2011-2012 and funds raising capital having a 9% hurdle rate.

Outlook

Many of the changes in the headline fees charged by real estate funds since the global financial crisis do not appear to be long lasting. Hurdle rates increased for a time, but are in many cases now lower for more recent funds. Rather than decreasing significantly following the financial crisis, management fees have remained fairly consistent. While the depressed fundraising environment in 2009 and 2010 appeared to spur fund managers to adjust fund terms and conditions slightly so they were more attractive for investors, the balance now seems to be shifting back. This process is slow, however, and some concessions that have been offered to investors in the wake of the financial crisis are unlikely to be reversed in a dramatic fashion.

Investors, of course, want to invest on the best terms possible, but they also want to invest with firms that can deliver superior returns and want to incentivize talented people. If higher management fees are necessary to operate a superior firm effectively, then many investors will see this as a price worth paying.

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