How to increase investment returns in real estate, without increasing the risk

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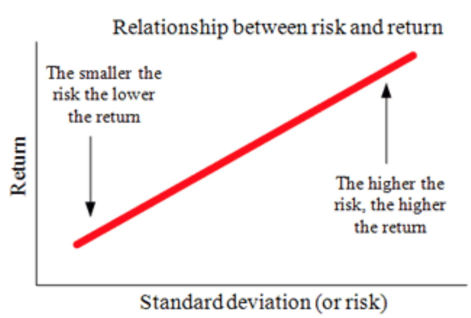
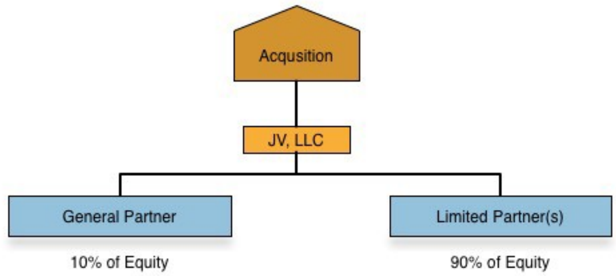
Private equity real estate is rooted in the underlying concept that there is an inescapable positive linear correlation between risk and reward when it comes to investment returns (i.e. the greater the returns the greater the risk and vice versa):



While this concept is true when holding all other assumptions static, in reality, the relationship between risk and return is more fluid and malleable. There is not simply one plotted relationship in this universe but an infinite number. More importantly, there are ways for individual investors to earn greater returns at each level of risk or "jump" upwards to a superior risk-return line. One such way is through co-investment in the General Partner side of a private equity real estate deal.



This structure is marriage of convenience between two parties: 1) Limited Partners (LP's) — groups that have money they wish to invest in real estate but are resource constrained in identifying and acquiring it and 2) General Partners ("GP's) — groups that possess expertise in acquiring and operating real estate in a geographic area but are resource constrained in capitalizing it. Deals that are capitalized under this structure involve the LP putting up the vast majority of total equity, typically 90%, with the GP putting up the remaining 10%.

Structuring a GP / LP JV deal commonly utilizes an incentive mechanism known as disproportionate sharing of profits or in industry slang a "promote". While GP's may only put up 10% of the equity they earn greater than 10% of the profits. LP's tolerate paying disproportionate shares of profits to GP's because a) they rely upon GP's in a multitude of ways (see below) and b) they want to incentive GP's to perform.

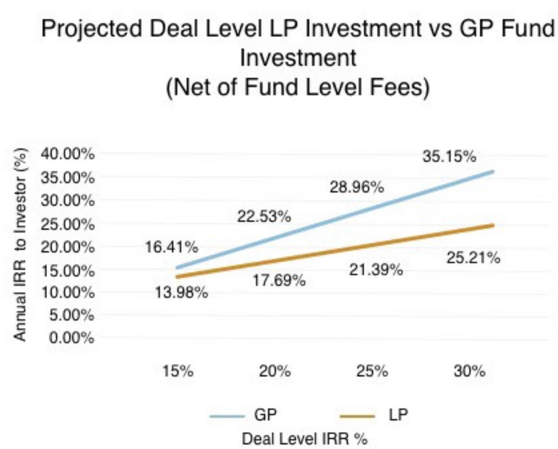
LP's rely upon GP's, among other things, to do the following in a JV deal:

1. Source and identify assets
2. Underwrite and discover hidden value
3. Pursue, negotiate and win deals
4. Develop asset business plans
5. Negotiate purchase and sale agreements
6. Conduct thorough due diligence
7. Secure financing
8. Close deals
9. Manage assets
10. Execute asset business plans

12. Deliver investment returns

Considering that GP's do most of the heavy lifting in a JV deal, it is fair and logical for GP's to earn a greater share of profits than their pro-rata equity participation would otherwise suggest. In addition, because LP's rely upon GP's to execute upon the items listed above, they want to incentive GP's to keep their eye on the prize and there is no better way to do this than to offer up the carrot of disproportionate profits participation.

So how can individual investors benefit from the GP / LP JV relationship? The answer is to invest directly into the GP's entity and earn a percentage of its promote on top of the standard LP profit share. This is commonly referred to as a "GP co-investment". By receiving a share of a GP's promote, the individual investor is able to move up to a superior risk-reward line and earn greater returns than the LP when measured against project-level returns as demonstrated below:



You might ask, "why would GP's share their promote with me, an individual investor?" The answer to that question draws back to the underlying reason why GP's pursue this structure in the first place — they are inherently capital constrained.

Consider the following scenario: a $60 million private equity real estate transaction that is capitalized by $40 million of debt and $20 million of equity. Under the typical 10% / 90% GP / LP structure, the GP provides $2 million to the LP's $18 million to do the deal. For the GP, whose business is to acquire and manage as many assets as feasibly possible, $2 million is a lot of balance sheet capital to expend on a single asset. For GP's, the highest and best use of its capital is to scale its operations, not heavily invest in each deal, no matter how attractive the deal may look.

To solve this problem, GP's seek to reduce the amount of balance sheet capital they invest in each deal in order to sprinkle capital into more deals rather than concentrate it into fewer deals. At the same time, while LP's always want GP's to have equity participation or "skin in the game" they often do not require it to be the full 10% of

As a result, GP's are often permitted by LP's to find other investors to help fund GP co-investment requirements and those other investors often comprise high net worth individuals. To attain the GP co-investment dollars, GP's are willing to share a portion of their promote since those co-investment dollars enable the GP to a) do the deal b) enjoy the opportunity to earn a promote and c) preserve precious balance sheet capital to fund the next deal.

The GP co-investment is that rare case when the little guy out earns the big guy in a deal; the private equity real estate equivalent of David versus Goliath. And that is why it's beautiful.

For more information on investing in commercial real estate with a private equity fund please visit www.encorewealth.bz or call Brandon Burns at 214.280.0908.