The Yin and Yang of Equity Multiples and IRR

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Great article by www.crowdstreet.com
https://www.crowdstreet.com/education/article/yin-and-yang-equity-multiples-and-irr/

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One of the keys to understanding IRR is realizing that timing plays an important role. The time or duration of the investment hold period and the timing that cash distributions are paid to investors both have a big influence on this equation. More details on IRR can be found in our earlier article (Understanding Internal Rate of Return (IRR) in Real Estate Investing).

What is an Equity Multiple?

In real estate, equity multiples are used primarily as a measure of the total return paid to an investor. The equity multiple is found by dividing the cumulative distributions from a project by the paid-in capital. The equity multiple differs from the IRR in that it does not take into account the length of the investment period or the time value of money.

Equity multiple = cumulative distributed returns / paid-in capital

Equity multiples and IRR are closely intertwined in real estate private equity. Another notable difference is that the equity multiple is static, while the IRR is variable. For example, if an investor puts in $100,000 and gets $200,000 back in total return, that is a 2x equity multiple - period. It has no bearing on how long it took to earn that return. It is a valuable exercise to overlay an equity multiple with IRR to get a sense of the total return that also accounts for the timing of the payout on that return. The faster an investor gets that return, the higher the IRR. If an investor gets 100% of that return – all $200K – in one year, that is a 100% IRR. However, if the investor receives that return in 5 years, the 2x multiple doesn't change, but the IRR drops, perhaps to 20%, depending on the timing of distributions.

As this example shows, all IRRs are not created equally. That is why it is important to look at IRRs in conjunction with equity multiples as a measure of total returns. Other key points to understand as to why it is important to look at both metrics include:

- The IRR is something that can be manipulated. That is an important consideration when looking at a sponsor promote structure that is IRR driven. A sponsor may be able to quickly hit an IRR target that will trigger payment of a sponsor promote, even if that means falling short of a projected equity multiple.

- In some deals, the equity multiples can provide an added layer of checks and balances by requiring the sponsor to achieve both an IRR and a certain level of equity multiple before the sponsor becomes eligible to receive a promote. You sometimes see this type of hurdle layered into an institutional JV co-investment structure.

- Investors may value equity multiples and IRR differently depending on their investment objectives. Investors that are more yield-driven may favor offerings with a higher IRR, whereas investors who focus on building long-term wealth may place greater emphasis on deals with a higher equity multiple.

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.