



## Equitable Terms – A Principle worth Defending as Funds Proliferate

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The number of private equity real estate funds pursuing opportunistic returns amid the fallout from the credit crunch continues to grow rapidly. In a recent position paper, fund of funds manager Clerestory Capital Partners argues that “equitable terms” for all investors is a principle worth defending.

“The results of our recent market survey clearly show that the proliferation of funds pursuing higher-returning investment strategies is continuing,” says Joanne Douvas, principal and co-founder of Clerestory. “But we also sense that the velocity of capital-raising has decreased significantly. This convinces us that the principle of equality of terms among investors in funds is even more crucial now, as we believe it leads to a more efficient management process, a better product, a higher-quality investor base and ultimately, better performance,” she adds.

Clerestory’s latest research shows 128 small-cap opportunistic funds in the market in first quarter 2008 seeking to raise US\$54 billion in equity, compared with 107 funds seeking to raise US\$45 billion in equity in the third quarter of 2007.

Small Cap Fund Universe	Global	Americas	Europe	Asia	Other	Total
1Q 08 SC-Opportunistic™ (number of funds)	2	51	24	47	4	128
1Q 08 SC-Opportunistic™ (total equity \$ billion)	\$1	\$19	\$11	\$22	\$1	\$54
3Q 07 SC-Opportunistic™ (number of funds)	5	44	14	39	5	107
3Q 07 SC-Opportunistic™ (total equity \$ billion)	\$3	\$17	\$7	\$17	\$2	\$45

Source: Clerestory Capital Partners, LLC proprietary research and publicly available sources (as of March 31, 2008); Core, Value-Add and Mezzanine funds not included in research.

Note: Clerestory defines SC Opportunistic™ Funds as those funds raising less than \$1 billion of equity capital.

“There continues to be an investor focus on growth in emerging markets, although in the US and European markets there are a number of new funds, or funds in formation, targeting distressed situations,” comments Clerestory principal and co-founder Tommy Brown.

But unsurprisingly, there is anecdotal evidence that it is the managers with proven performance who are capturing the lion’s share of capital, Brown says. Mediocre performers, or those that have invested capital in the past few years with no realisations, are having a harder time capturing investors’ attention.

“Investors are reserving investment capital for existing fund managers and holding back money for new funds,” Brown notes. “It will be some time before we can discern whether a fund has had a successful capital raise, as many are resizing their target raise, or extending their final close dates.”

### Equal Terms

While a lot of attention and industry debate has focused on the management-fee structures of non-listed real estate funds, relatively little comment has focused on the other side of the equation, where investors



demand preferential terms from managers. It is this aspect of the manager/investor relationship that Clerestory has addressed in its recent position paper, "Fair Trade: The Wisdom of Setting Equal Terms."

"As we evaluate funds and managers for our own real estate fund of funds, we see the best results come when the goals of all participants are aligned, smoothing the path to the best opportunities," the Clerestory principals note in the paper. "We believe that the surest route to harmony is establishing the same terms for all investors in a real estate private equity fund, for those that are institutional in size."

Brown and Douvas admit that a lack of broadly accepted "market terms" in the private equity real estate world – with widely ranging governance standards from fund to fund – may make consensus on terms difficult. For their part, the Clerestory principals say they adhere to several tenets in negotiating terms:

- Same terms for all investors, regardless of size (with the exception of fee breaks for certain commitment amounts)
- Fair compensation for performance
- Fair and even-handed governance that promotes transparency and good communication, while holding the manager to a high fiduciary standard

Douvas notes that, while the goal of equal terms is not always easy to achieve, the benefits are many. "It isn't just the right thing to do," she argues. "In the long run, it's also the smart thing to do."

### **Better Process**

Equitable terms, Douvas maintains, ensure a more efficient pre-close process, almost by default. It's not unusual for large investors and aggregators of capital to seek favoured terms such as a share of general partner carry, exclusive co-investment rights, a reduction of limited partner carry paid, or exclusive rights to a UBTI clawback. Several arguments are made for these special terms, Douvas notes, such as payback for doing the heavy lifting in document negotiation, or "insurance" for taking on a de facto leadership role.

"We appreciate the practical reasons for such demands but still find the benefits of fair terms outweigh the need for such rewards," Douvas says. The focus of stepping up early, Clerestory believes, should be to negotiate fair, even-handed fees and terms, and to foster good governance and transparency from which all participants benefit.

"In our experience, special terms encumber the fundraising and investing process," the principals write. "A favoured deal for a particular investor often results in the creation of a separate, parallel fund solely for the one investor – which immediately incurs added legal fees and, later, will produce process inefficiencies throughout the life of the fund."

### **Better Product**

Clerestory also argues that limited partners who focus on special terms early in the marketing cycle may fail to negotiate the rest of the document for standard market terms or good governance. Setting a goal of fair terms for everyone from the start, they say, ensures that contract negotiations are about fully vetting partnership terms, not rethinking them for each investor.

"We see the results of well-conceived terms after a fund closes," Douvas notes. "Take co-investment, for example. Market practice holds that all investors are entitled to their pro rata share. If fair terms have been negotiated, all investors are poised to put up any needed additional capital for a deal relatively efficiently. However, if a manager has granted exclusive co-investment rights to a small subset of investors, problems can arise when pursuing large deals that require a larger-than-usual amount of co-investment capital."

In such cases, limited partners may be unwilling to devote much time underwriting a deal in which they may not be able to participate – thus inhibiting the general partner's ability to execute on a larger opportunity.



## **Better Investor Base**

Special terms will always attract influential investors to a fund, but evidence suggests that the goodwill that comes from equal terms attracts some of the best investors. Douvas and Brown say that's because quality investors – the kind that lend their imprimatur to a fund by their very presence – seek out confident managers whose fund strategies stand on their own merits. By contrast, they believe favoured terms may send the wrong signal to sophisticated investors, who won't want to, in essence, subsidise the special deal.

Douvas says she has seen examples of fund managers who, in exchange for large capital commitments, have given investors shares of their carry. On occasion, this has resulted in an entire fund only comprising of the initial capital, because no additional money followed the "special" investor into the vehicle.

"We would even argue that there is a reputation risk for the special-terms-seeking investor," Brown says. "Such behaviour not only creates ill will among the fund's investor base; down the line, it can lead general partners of other funds to market to that investor last, so as not to chase others away."

While there are no guarantees in private equity real estate investing, Douvas and Brown believe aiming for equitable terms can lower obstacles to achieving outperformance. It gives funds access to the right capital and their best shot at worthwhile opportunities. And, Clerestory argues, over the long-term, limited partners who conform to principles like these reinforce their reputation for fair dealing and quality investment.

Equitable terms is a principle worth defending Douvas and Brown conclude, adding: "An approach like this only succeeds when both managers and investors cooperate."

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*This article first appeared in the June 2008 issue of The Institutional Real Estate Letter, published by Institutional Real Estate Inc ([www.irei.com](http://www.irei.com)).*