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REAL ESTATE JV PROMOTE CALCULATIONS: RECYCLING PROFITS

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This article supplements a previous article published in the Spring 2003 issue of The Real Estate Finance Journal entitled “Real Estate JV Promote Calculations: Basic Concepts and Issues”. As described in that article, it is relatively common for a service partner to receive a promote in the form of a greater share of profit distributions after an IRR hurdle is achieved. This article will discuss problems from the viewpoint of the capital partner associated with recycling profits, where a capital partner’s profits in excess of the IRR hurdle are taken into account in determining whether the IRR hurdle is met in the future.

Turn back the clock and imagine this: an investment fund forms a partnership with a local operator and provides all the equity capital to acquire a San Francisco office building just before the dot-com craze. Under the partnership agreement, the operator is entitled to half the distributions (a “**promote**”) after the investment fund has received a 10% IRR (basically, after it has received a 10% annual return and recouped its investment). The investment is a success. A year after the purchase, rents skyrocket and the operator is able to refinance for so much more than the original investment that there are \$8 million of refinancing distributions in excess of the 10% IRR hurdle. The investment fund then has a 50% IRR (including \$4 million of profits in excess of the 10% IRR hurdle) and the operator has a \$4 million promote! The investment fund distributes its share of the proceeds to its investors, who are ecstatic. A few years later, the tech-stock bubble bursts, the building loses its tenants and the investment fund is required to invest \$4 million of additional capital to re-lease the building. During the re-leasing process, it becomes clear that more capital will eventually be required to fund operating deficits. Rather than invest further capital (because the investors don’t want to spend any more money), the partnership sells the property and the sale generates (after reserves for liquidation) \$1 million of net sale proceeds. Even with the additional investment, the investment fund still has more than a 10% IRR before the final distribution, so the net sale proceeds are split 50/50. The operator walks away with an additional \$0.5 million promote (for a total of \$4.5 million). In the end, the investors are not happy, but the investment fund has significantly more than a 10% IRR for its entire investment in this building.

Both the investment fund and its investors had assumed that the investment fund would always get more than 1/2 of the “**whole dollar profits**” (i.e., the amount by which (x) total distributions exceed (y) total contributions) because they were getting a 10% return before any profits were split with the operator. Yet it did not work out that way. In the end, there were \$6 million of whole dollar profits, and the investment fund received only \$1.5 million, while the operator received three times as much, \$4.5 million. Basically, the investment fund recycled \$4 million of profits above the 10% IRR to fund the additional investment, most of which was lost. How did this happen? And what might have been done to avoid this result?

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This article will attempt to answer these questions and, more generally, discuss the problems associated with recycling profits.

Definition of Recycling Profits. In this article, “**recycling profits**” means that a capital partner’s “post-hurdle distributions” (i.e., distributions in excess of an IRR hurdle) are taken into account in determining whether the IRR hurdle is met in the future.

Assumptions. To simplify the discussion, this article assumes that, as in the above story, there is a partnership between a capital partner (“**Investor**”) and a service partner (“**Operator**”) in which:

- Investor is responsible for 100% of the capital contributions; and
- all distributions are made first 100% to Investor until it receives a 10% hurdle (i.e., all of its capital and a 10% annual return, compounded annually) and then the balance is distributed 50/50.

Definition of IRR. Unless otherwise indicated, references in this article to Investor’s “**IRR**” as of any moment in time will mean the annual rate which, when compounded annually, makes (A) the present value of all Investor’s contributions made at or before such moment equal (B) the present value of all Investor’s distributions made at or before such moment.^{1/} Here are two observations about the IRR, which are fairly easy to prove, but which this article will take for granted:

- The present values of the contributions and distributions in question may be the discounted values as of the commencement of the partnership or they may be calculated as of any other point in time as long as the same point in time is used for (A) and (B).
- If Investor has a certain IRR as of a particular moment, then it will have the same IRR until the next contribution or distribution. In other words, the IRR doesn’t change until there is another contribution or distribution.

EXAMPLE 1: To flesh out the facts of the above story, assume the following slightly simplified facts: (1) at the beginning of year 1, Investor makes a \$10 million contribution to provide the equity capital for a \$50 million purchase of an office building; (2) at the beginning of year 2, there is a \$19 million refinancing distribution; (3) at the beginning of year 3, Investor makes an additional \$4 million contribution; (4) at the beginning of year 4, the building is sold and there is a final distribution of \$1 million; and (5) there are no other contributions or distributions.

Under these facts, the contributions and distributions can be summarized as follows:

EXAMPLE 1			
DISTRIBUTIONS:		Investor	Operator
Refi Distribution:	\$11.0 million hurdle <u>\$ 8.0 million balance</u> \$19.0 million	\$11.0 million \$ 4.0 million	\$0.0 million \$4.0 million
Sale Distribution:	<u>\$ 1.0 million</u> \$20.0 million	<u>\$ 0.5 million</u> \$15.5 million	<u>\$0.5 million</u> \$4.5 million
CONTRIBUTIONS:			
Initial Contribution:	(\$10.0 million)	(\$10.0 million)	(\$0.0 million)
Subsequent Contribution:	<u>(\$ 4.0 million)</u> (\$14.0 million)	<u>(\$ 4.0 million)</u> (\$14.0 million)	<u>(\$0.0 million)</u> (\$0.0 million)
WHOLE DOLLAR PROFITS:	\$ 6.0 million	\$ 1.5 million	\$ 4.5 million

In Example 1, Investor has an approximate 15.31% IRR immediately after the additional contribution and continues to have the same IRR until immediately before the final distribution (as explained in the following calculation).

EXAMPLE 1

IRR CALCULATION

To calculate the IRR in Example 1 after the additional contribution and before the final distribution, we look for an annual rate which, when compounded annually, equalizes the present values of Investor's contributions and distributions immediately after the additional contribution. As noted earlier, it doesn't matter what day during that period we choose because there are no contributions or distributions during that period. The IRR turns out to be approximately 15.31%:

(A) Present Value (@ 15.31%) of
Contributions (after year 3 contribution):

$(\$10 \text{ million} \times [1.1531]^2) + \$4 \text{ million},$

which is approximately \$17.3 million.

(B) Present Value (@ 15.31%) of
Distributions (after year 3 contribution):

$\$15 \text{ million} \times [1.1531],$

which is approximately \$17.3 million.

When Investor contributed the additional \$4 million, it may have expected that this money would be treated like a new investment that Investor would recoup, together with a 10% annual return, before any further distributions would be shared with Operator. This would have happened if the \$4 million post-hurdle distribution had not been taken into account in the IRR calculation. Instead, Investor's \$4 million post-hurdle distribution (received a year earlier) was in effect recycled into the project and credited against the \$4 million of subsequent contributions (as explained in the following calculation).

