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CAPITAL

Transcript

How are incentives and fees structured? - B-Long

The fees and incentives are incredibly important when evaluating a deal, especially in private equity real estate. We want to make sure that that sponsor has every incentive possible to give us the highest return possible. And there's various levers involved in the waterfall to make sure that happens. So if you remember how a waterfall works. Generally you get a preferred return of some level.

You get a return of capital, and then you'll have splits that you share with the sponsor. And we really want to make sure that that sponsor is incentivized to get the highest return possible because it benefits them. And if it benefits them, it benefits us. So let me give you an example on that. Had an investor tell me a story about how excited they were to invest in this project that had a 90/10 split after they got their money back.

In other words, they were splitting the profits 90% to the investor and only 10% of the sponsor. And that investor was so excited because they were going to get the lion's share of the profit. Then I asked him, what incentive does the sponsor have if they're only getting 10% to produce a great return for you?

The incentives weren't there. And after digging into the PPM even further, we realized they had an outsized acquisition fee up front. So they got paid a lot of money when they closed. They had an outsized management fee or developer fee along the way. So they got paid a lot of money along the way. And then a teeny tiny profit split at the end.

That's not in the investor's best interest, because if you did the math, the sponsor made 4 to 5 times the money that the back end. Little 10% would have given them. So where was their incentive to run the project as profitably as possible? That's what we want to look out for. So alignment is incredibly important. We look at co-investment.

That's another item. Is the sponsor invested in the project with their own money and how much so. And we also got to follow up to make sure that they are. So a lot of times we'll have the sponsor invest in our account and then turn around and send the money at closing to title, because we want to make sure that they didn't just say it, they actually did it. But their co-investment is super, super important because they have skin in the game.

I want to look at all the fees that they're making and I want them to make money. This is very important.

I want my development partners to be profitable. If they're profitable, we're profitable as investors. So you don't want to skinny it down to where it's not even worth it for them to do the job. It's got everyone's got to win. This is truly got to be a win win. But there's different levers that are involved. And we'll educate you on this on a per deal basis.

Once we get into an actual project to understand why we like the structure, or maybe if we're looking at something and pass on it, why we didn't like the structure, because alignment is incredibly important. I want the incentive to be the better the return, the better money the sponsor makes, because that means the better money our investors will make.