OAK INVESTMENT MANAGEMENT GROUP

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Hurdles in Real Estate

'Carry' in private equity industry, 'options' in corporate world, 'profit share' in development business and 'promote' in investment management are all different names for the same type of incentive structure. They seek to motivate management to equal or surpass pre-designated hurdles above which a fixed or proportionate amount of extraordinary payment is promised. These amounts can be paid out in cash or in specie of the equity value that has been created. These are attempts to overcome the agency problem between owners of the business and management whose motivations can never be completely aligned. Promotes are therefore an attempt to create the payoffs of equity synthetically.

There are lots of different types of promotes, and many layers that can be overlaid upon one another which creates what is known as a 'waterfall' structure. Practically speaking a waterfall structure can get quite complicated. However, all best incentive structures are simple to understand. Simplicity is the best aid to getting the most out of everyone concerned. Ultimately goals and rewards should be clear, otherwise it breeds the disunity of purpose that promotes are initially designed to overcome.

When negotiating a promote there are two competing pressures. On the one hand, management consciously or subconsciously tries to construct a promote that is as riskless as possible, or, represents merely the performance of the market (also known as beta) rather than performance attributable to their performance (also known as alpha). On the other hand, owners can be unrealistic in base assumptions and set hurdles too high. There is no better way to dis-incentivise management than to offer them an out-of-the-money promote. This is demoralising and a waste of time, insofar in these circumstances it would be better not to have any promote structure at all.

There are distinct types of real estate investing and all promote structures should be reflective of the risk / reward profile that the investment represents. For example, it would be inappropriate to bucket a development site together with a mature asset. The former will involve managing large inputs, outputs and (hopefully) rewards. The latter will involve iteratively managing margins, relationships and (hopefully) incremental upward returns. Another consideration in constructing a promote is scale. In some cases, the role of the manager (no matter how excellent) cannot take the same proportion of the upside simply because the weight of risk capital in proportion to the goodwill potentially created by the manager is so large in favour of capital.

Promotes in real estate should be robust to withstand the vicissitudes of investment and life. And if a promote fails in its primary aim, owners need to be circumspect in re-setting them. Promotes do not in themselves create goodwill it is the instinct that engender them that does. After all, as long as a real estate owners and managers feel that they are a team working to a common goal then value will be created by that platform.

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