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Capital Conundrum

Does sponsor equity make sense to fund investments?

by Jeffrey M. Friedman and Andrew M. Halbert

An attractive investment structure is gaining traction in the world of private equity real estate, offering an alternative way for sponsors of real estate projects to fulfill their capital contribution obligations. Increasingly, sponsors are offering investors the opportunity to contribute a portion of the capital that would typically be directly contributed by the sponsor or its affiliates — known as sponsor equity — rather than investing as a limited partner. Risks and benefits come from investing in sponsor equity.

For a typical real estate deal, a joint venture is formed for the project, either a limited liability company or limited partnership, with the sponsor or an affiliated entity serving as the manager or general partner. In such capacity, the sponsor is expected to raise capital for the project, manage the day-to-day operations of the project, and contribute a meaningful portion of the capital required for the project.

Sponsor Equity Structures

As compensation for the sponsor's services, in the final tiers of the waterfall distribution schedule, the sponsor is usually entitled to receive a larger percentage of the profits beyond its capital contribution percentage, which is called the promote or carried interest.

Since many sponsors are involved in multiple projects and do not receive such promote distributions until the later stages of a project, some sponsors do not have access to sufficient capital to pursue all of the potentially profitable opportunities. With the current strength of real estate markets and continued growth in transaction activity, capital-constrained real estate private equity sponsors are increasingly offering the opportunity to invest in sponsor equity. This added source of capital allows them to pursue more investment opportunities.

If the sponsors are only seeking sponsor equity for one specific project, they might approach a few investors and form the manager and general partner entity for that project as a joint venture with those investors.

Alternatively, the sponsor could form a sponsor equity fund that would raise a larger amount of money through a more traditional private offering, which could then be used to contribute portions of the required sponsor equity for multiple projects. The key terms of these structures can vary, but some common provisions are summarized below.

Distribution and Management Fee. If a sponsor establishes a fund to contribute sponsor equity for multiple projects, investors will likely pay a management fee to the sponsor based on the

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amount of capital invested by the fund. Distributions typically follow the traditional private equity structure, in which investors receive a return of their capital plus a preferred return, and any profits remaining after the payment of the preferred return and the return of capital are split between investors and the sponsor pursuant to a predetermined formula.

Fees and Decision-Making. These sponsor equity opportunities are attractive to investors because they typically share in the promote distributions. Investors in sponsor equity, however, generally do not share in fee income, which is the management fee, received by the sponsor. These fees are usually paid as compensation for services, such as property management, leasing, or financing, provided by the sponsor or its affiliates. Since investors in the underlying real estate project are depending on the sponsor to make all management decisions, including those related to the services described above, investors in sponsor equity are offered limited, if any, decision-making rights.

Advantages and Constraints. Given the economic advantages of investing in sponsor equity, including more favorable returns as compared to a typical real estate investment, what constrains a sponsor's ability for this investment opportunity? Primarily investors have grown accustomed to sponsors contributing a significant portion of the required capital.

Syndication of Sponsor Equity. Accordingly, if a sponsor intends on syndicating the sponsor equity for a particular project, the syndication should be disclosed in the offering documents. Some investors may worry that as a sponsor syndicates its required capital contribution, the sponsor may make riskier decisions because less of its capital is at risk.

However, even if a sponsor has less capital at risk, it has an incentive to make sound decisions because of its desire to raise more funds for future projects. Also, sponsors will only realize a return on a project if it becomes profitable.

Balancing Concerns. Sponsors will need to balance these concerns and work with their investors to ensure that all parties involved are comfortable with the amount of sponsor equity that will be provided by investors that are not affiliated with the sponsor. When the balance is achieved, investments in sponsor equity may be a great opportunity for both capital-constrained sponsors and investors.

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