SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

Valuation Viewpoint

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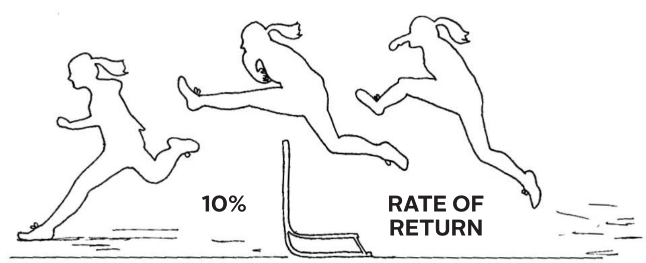
Waterfalls and Hurdle Rates in Real Estate Private Equity

by Madeline Strachota

What is better—tiered returns or pari passu? It's up to you.

Private equity organizational structures have various merits and demerits. Appraisers see a variety of entity structures—partnerships, limited liability companies (LLC), corporations—all organized in different ways, which makes understanding the governing documents of an entity essential to understanding the value of an interest in that entity. Some of the most common reasons for the variety of organizational structures include optimizing wealth transfer in estate planning, tax planning, liability mitigation, incentive alignment, and role allocation based on what each partner brings to a deal.

As an asset class, private investment in real estate has grown substantially in the 21st century. In fact, it was not until the 1990s that real estate private equity in the form of pooled funds for investment in real estate became popular. These funds grew out of private investors pooling to take advantage of falling real estate prices in the early 1990s and have continued to grow in popularity, especially in the build up to the Great Recession. In all economic cycles, investors choose real estate to add diversification to their portfolios, and because the assets are income producing, hedge against inflation, and are tangible. Within real estate private equity, there is a



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Market Trends and Value Indicators

Office Buildings—Downtown	→	0.0%
Office Buildings—Suburban	→	0.0%
Retail Centers	→	2.0%
Industrial Buildings	↑	3.0%
Apartments	→	2.0%
New Housing Starts—Midwest*	↓	-2.4%
Productivity**	↑	2.4%
US Unemployment***	↓	3.3%
Consumer Confidence Index***	↑	131.4%

Statistics reflect year-over-year value change from:
* YoY April 2019 ** YoY 1Q 2019 *** May 2019

In This Issue ...

Spotlight on South Loop

by H. Ellis Beck

Throughout its history, the northeastern portion of Bloomington, Minnesota has been home to plenty of notable developments. This corner of a second-ring suburb, sandwiched between the Minnesota River and major highways, has hosted farms, a wildlife refuge, a professional football and baseball stadium, a professional hockey and basketball arena, huge surface parking lots, hotels, and a dedicated space for landing approach lights for Minneapolis-St. Paul International Airport.

Today, the area still has the wildlife refuge, the airport lights, and hotels, but the professional sports venues and their parking lots have been replaced by the Mall of America and Ikea. Since the 2004 opening of the Blue Line, which connects the Mall of America to the airport and Downtown Minneapolis, office buildings and multi-family developments have sprung up around the district's stations.

The South Loop's population, households, and housing units are projected to more than triple from 2010 through 2050.

Still, the area now known as the South Loop sees potential for more growth in its future and announced that potential to the world when the site finished as a finalist to host the 2023 World's Fair, before eventually losing the bid to Argentina. It announced it again by entering a bid to host the 2027 World's Fair, the winner of which has not yet been announced.

Most of this excitement for potential growth centers around the South Loop District Plan, adopted by the Bloomington City Council in August of 2013. The plan focuses on leveraging the area's existing assets to foster responsible growth. These unique assets include the country's largest mall, which serves 40 million visitors annually, and the district's close proximity to Minneapolis-St Paul International Airport, a major hub for Delta Air Lines. The area is home to four light rail stops, increasing opportunity for Transit-Oriented Development and improving walkability throughout the area. A map by the City of Bloomington highlighting the existing assets is below.

So, what does the city think "built out" looks like for the South Loop? Below are the published projections for the area.

South Loop Demographic Projections, 2010–2015

	2010	2030	2050	% Change 2010–2050	Annual % Change
Population	2,025	4,852	6,739	233%	3.1%
Households	1,044	2,758	3,856	269%	3.3%
Housing Units	1,166	2,956	4,102	252%	3.2%
Employment	30,946	44,793	58,976	91%	1.6%

Source: City of Bloomington, 2009

The South Loop's population, households, and housing units are projected to more than triple from 2010 through 2050. The annual population growth rate of 3.1% would roughly quadruple growth rates anticipated in Hennepin County over the same period, and Bloomington expects that over two-thirds of its population growth will occur in the South Loop. Households and housing units are anticipated to follow a similar trend. While employment growth is anticipated to lag population, household, and housing unit growth, the South Loop already serves as an employment hub due to the Mall of America's presence.

South Loop Development by Land Type, 2010–2015

	2010	2030	2050	% Change 2010–2050	Annual % Change
Office and Tech	3,174,000	55,98,000	8,574,000	170%	2.5%
Retail	4,575,000	65,95,000	8,125,000	78%	1.4%
Hotel Rooms	2,884	4,876	6,126	116%	1.9%
Residential Units	1,116	2,956	4,102	268%	3.3%

Source: City of Bloomington, 2009

Residential units are projected to grow at roughly the same rate as population and households, with office and technical space lagging only slightly behind. Growth in retail and hotel space is anticipated to trail the housing sector, but the South Loop clearly has an established retail base and is already a hotel hub due to its mall and proximity to the airport.

To encourage growth at the projected rates, the city updated its land use plan to emphasize density, walkability, transit, and public green space, as seen in the map below.

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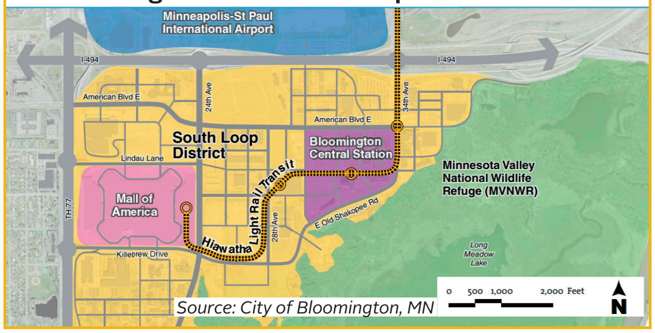
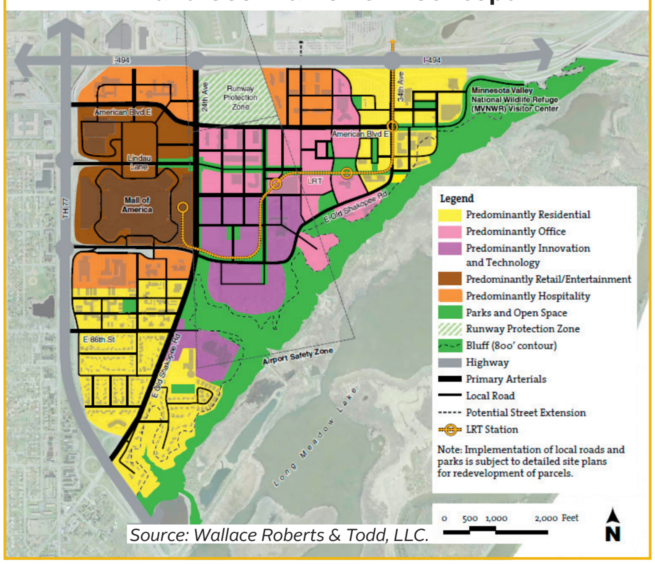
Spotlight on South Loop *continued from page 2*

Existing Influential Development Features



Source: City of Bloomington, MN

Land Use Framework Concept



Source: Wallace Roberts & Todd, LLC.

The South Loop exemplifies the growing trend of suburbs transitioning portions of their land from the open, auto-centric, and decidedly "sub-urban" style of planning to a far more dense, transit-oriented, walkable, and "urban" style. We've seen this trend play out in mid-size metropolitan areas; Seattle and Denver area suburbs have recently attempted to build around new or planned transit corridors. However, Bloomington's situation is unique in the Minneapolis-St. Paul area.

Locally, suburbs have begun to either prepare to reshape downtown areas to accommodate incoming transit (such as along the Southwest Rail Line) or totally rebuild areas from the ground up (e.g. the Ford Site in St. Paul). The South Loop is uniquely positioned in that the "hard part" is already accomplished: trains are already running through the area, people are already coming to the Mall and nearby airport, the groundwork is already laid. The South Loop's continuing development from Bloomington's rural "front door" to its fully built-out form should prove interesting to observe.

Market Trends and Indicators

Economic Indicator

New Housing Starts— Midwest Yearly Totals	2012	2013	2014	2015	2016	2017	2018	Apr 2019
	127,900	149,600	162,500	152,600	182,300	179,600	171,800	42,300*

Source: United States Census Bureau

Rates of Return and Risk Hierarchy

Investment	
30 Year Treasury	2.94%
Aaa Bond	3.53%
Bbb Bond	3.82%
Commercial Mortgage	4.75–5.50%
Institutional Real Estate	6.0–7.5%
Non-Institutional Real Estate	8.0–10.0%

Investment	
S & P Equity (Duff & Phelps)	10.30%
Equipment Finance Rates	10.0–12.0%
Speculative Real Estate	11.0–16.0%
NYSE/OTC Equity (Duff & Phelps)	13.70%
Land Development	12.0–25.0%
NYSE Sm Cap. Equity (Duff & Phelps)	16.73%

As of June 10, 2019

Sources: United States Census Bureau, Pratt's Stats®, Bureau of Labor Statistics, Bureau of Economic Analysis, The Conference Board, Yahoo Finance, Duff & Phelps. Shenehon Company makes every effort to ensure the accuracy of the information published in *Valuation Viewpoint*. Shenehon Company uses only those sources it determines are accurate and reliable, but makes no guarantee with regard to the information presented.

common entity structure that seeks to align entrepreneurs and investors: the equity waterfall.

Each equity waterfall can be different; however, the main idea is to decide which partner(s) control the everyday operations of the deal and how distributions are made to the different equity classes. Oftentimes these funds are structured as partnerships with one general partner and many limited partners. Unlike entities that distribute capital on a pro rata (also known as pari passu) basis according to what portion of the initial investment each investor contributed, waterfalls distribute capital by splitting distributions unevenly among partners after certain performance milestones, known as hurdles, are met.

But why would investors agree to receive a distribution that is not proportionate to their initial investment? The rationale is that entrepreneurs bring ideas and investors bring capital. As such, each partner needs to be compensated for what they bring to the table and the relative risk they bear. When capital markets are flowing and good deals are sparse, organizational structures skew to provide a higher reward to the entrepreneur. Alternatively, if capital markets are tight and deals are plentiful, organizational structures skew to favor the "money" investors. Furthermore, a waterfall structure incentivizes the general partner to achieve higher rates of return because at each higher rate of return, the general partner receives a disproportionately higher percent of the distributions compared to the limited partners. Lastly, oftentimes the entrepreneur bears most of the up-front costs associated with real estate development or investment; as such, they must be compensated for this higher level of risk.

Most waterfall models follow the same general principals; however, organizational documents can specify different arrangements that materially impact management decisions and distributions. Although entity management and distribution allocations are the key differentiators, an infinite number of provisions in the organizational documents can impact value. For example, there may be a general partner or managing member that controls the entity and receives separate returns; other times there are equally divided interests, each with management voting rights. In another arrangement, some equity partners are entitled to a "guaranteed" preferred return over other equity partners. Furthermore, members, partners, or shareholders could be individuals, LLCs, partnerships, or corporations, and these subsidiary entities could have equally complex structures.

Following are a few additional differentiators among waterfall agreements and why they might matter:

The provision. Distributions based on individual investments versus aggregate investments.

- → **The impact.** If a fund has one investment that performs extremely well, crossing the highest hurdle, but the other investments are a "bust," the general partner may receive an excessive return on the successful investment, and there may be no returns to any partners on the other investments.

The provision. A clawback provision.

- → **The impact.** If a fund does not perform consistently over time, historical distributions made to a general partner can be clawed back and redistributed to limited partners.

The provision. General partner in both the voting and nonvoting equity pools.

- → **The impact.** Whether the entrepreneur is in the deal as a common equity investor and/or a controlling investor entitled to the promote will determine how the equity splits flow.

The provision. The waterfall difference between operating cash flow and reversion cash flow.

- → **The impact.** If the waterfall specific to operating cash flow favors the general partner as compared to the waterfall specific to reversion cash flow, this incentivizes the manager to hold investments instead of selling.

It is important to understand the governance of an organization with an equity waterfall distribution to fully understand the potential upside and downside of investments. Additionally, to better

Typical Waterfall Structure

Step 1

Initial investment in the fund is $100,000.

Timing	Pooled Investment	Total Invested Capital	Entrepreneur	Other Investors	Split
Year 0	Initial Investment	$100,000	$10,000	$90,000	10/90

Step 2

The fund collects net operating income and proceeds from selling the real estate asset at the end of Year 1.

Timing	Total Return	Total Cash Flow
Year 1	NOI and Reversion	$120,000

- Total Investment Return is 20%
- Waterfall determines investor-level returns

Step 3

The governing documents of the fund dictate terms of an equity waterfall.

Timing	Level of Return	Total Cash Flow		Entrepreneur	Other Investors	Split
Year 1	Return of Capital	$100,000		$10,000	$90,000	10/90
	0-10% Return	10,000		1,000	9,000	10/90
	10-11% Return	1,000	The return above a pari passu arrangement is known as the "promote."	150	850	15/85
	11-12% Return	1,000		200	800	20/80
	12-13% Return	1,000		250	750	25/75
	>13% Return	7,000		2,100	4,900	30/70
	Total Cash Flow	**$120,000**		**$13,700**	**$106,300**	11/89

Waterfall Results
- **Total Return to Entrepreneur: 37%**
- **Total Return to Other Investors: 18%**

Compared to…

Pari Passu Results
- **Total Return to Entrepreneur: 20%**
- **Total Return to Other Investors: 20%**

understand what cash flows to the entrepreneur, investors should consider the additional fees to entrepreneurs that hit the income statement and are not considered equity distributions.

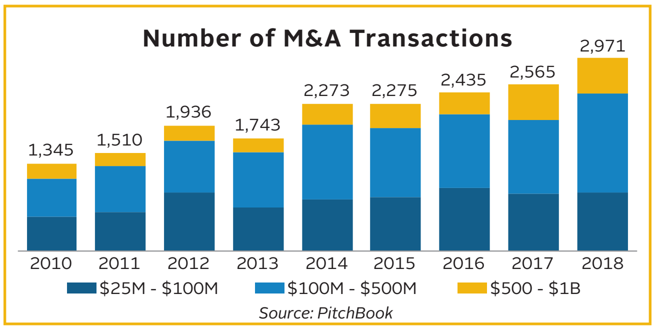
Real estate private equity has championed the use of waterfall structures for operating and reversion distributions. Although the intent of the waterfall organizational structure is good, the complexity of the structure begs the question—is it necessary? For those inexperienced with this asset class, the structure of these pooled investment funds can seem overly complex. Some critics argue that this structure falls into the category of the exact opaque financial practices that gave way to the Great Recession. Of course, with any partnership structure, the fiduciary is trusted to make value creating decisions for all partners, and it is possible to exploit investors that do not have specialized knowledge of real estate finance. However, the waterfall structure alone is not problematic—sure, it may create additional work for accountants and appraisers—yet many argue that this structure efficiently allocates risk and demonstrates an evolving sophistication in the industry. Time will tell if investors demand simplified organizational structures for the sake of transparency.

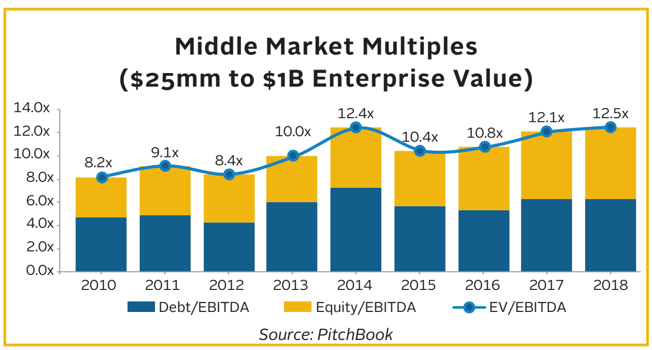
Mergers and Acquisitions

by Jim Clancy, Managing Director, HENNEPIN | PARTNERS

Strong M&A Market Pushing Higher Valuations and Increasing the Total Number of Transactions

Led by a strong economy and the prolonged bull market in stocks, we continue to see strong growth in the number of deals and valuation multiples in middle market M&A.

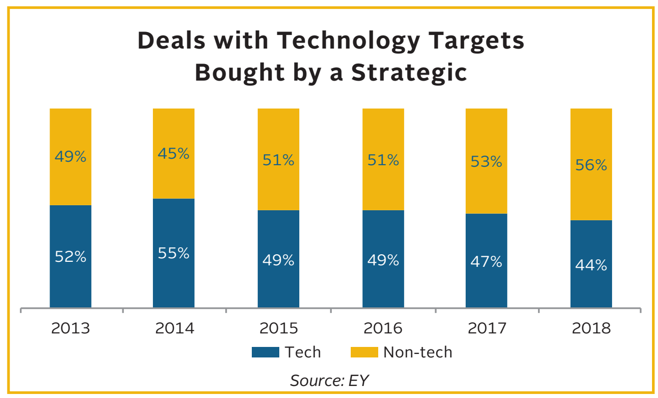




According to PitchBook, private equity firms set a new record by closing over $400 billion of middle market M&A transactions in 2018. At year-end 2018, PE firms had experienced another year of robust fundraising and strategic acquirers had grown their cash balances to unprecedented levels. Lenders have provided additional support to the M&A market. Fierce competition between acquirers with the resources and desire to acquire middle market companies is driving historically high valuation multiples. This holds true across market segments, including the industrial technology and software sectors.

Industrial Technology and Software: Non-Tech Companies are Using M&A to Stay Ahead in Fast-Changing Markets

According to EY, non-tech strategic buyers have closed more technology deals than technology buyers for four years running. With technology companies continuing to disrupt many industries, traditional incumbents are using acquisitions to leapfrog the process of developing technology in-house.



Much of this momentum has been driven by a positive reaction from the public markets. Non-tech companies have been rewarded for making acquisitions that embrace digital transformation and accelerate innovation. According to EY, the 15 most acquisitive non-tech companies made 110 technology acquisitions from 2012 to 2018. EY has also shown that non-tech acquirers are capable of paying higher multiples. In 2017, non-tech buyers acquired software assets at a roughly 15% premium compared to their tech counterparts.

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Mergers and Acquisitions *continued from page 6*

ASSA ABLOY Acquires KEYper Systems

This trend can be seen in a recent transaction arranged by Hennepin Partners in which KEYper Systems, a Charlotte, NC-based supplier of electronic and mechanical key management systems, was acquired by ASSA ABLOY.

KEYper Systems is an industrial technology company with advanced software solutions and a particularly strong presence in the U.S. automotive segment. ASSA ABLOY is a Sweden-based global leader in door opening solutions best known for its locksets, cylinders and door closer brands, including Yale and Sargent. By acquiring KEYper, ASSA ABLOY gained immediate access to new technologies, products and markets.

Sale of Former First Precinct

by Victoria Mercer

Seller: Goldman Sachs/R2

Buyer: Fifth Street Commons LLC

Sale Date: Early May 2019

Sale Price: $900,000

The historical building at 25-33 South Fifth Street served as Minneapolis Police Department's First Precinct for 25 years. First constructed as two distinct buildings in 1885, half of the structure has two stories and the other has four. The building has previously housed the Chamber of Commerce and Robins Kaplan headquarters. The building has been vacant since the first precinct departed almost ten years ago, and is currently completely gutted.

The property was purchased for $1.9 million in 2014 and valued by the assessor at that same price earlier this year. The buyer sought an as-is cash transaction and few buyers in the market wanted to take on the necessary renovations.

Fifth Street Commons LLC's renovation plans include updating the HVAC system to separate from the building next door and connecting to the downtown skyway system. The interior design will incorporate the building's exposed brick and timber. The second through fourth floors will house office tenants and the first floor will have a non-retail business storefront. Ownership anticipates the renovations will be completed by the end of 2021, resulting in a renovated Class B space which will rent between $25 and $28 per square foot gross with an expense stop.

SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

88 South Tenth Street, Suite 400
Minneapolis, Minnesota 55403
612.333.6533
Fax: 612.344.1635
www.shenehon.com

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Contributors:
H. Ellis Beck, Jim Clancy, Robert Strachota, Madeline Strachota, and Victoria Mercer