Club Deals – The Convergence of Commingled Funds and JVs

- Matthew A. Posthuma, Partner and Walter R. McCabe, Partner, Ropes & Gray LLP

Two of the traditional means for institutional investors to privately invest in commercial real estate are the commingled fund and the joint venture (JV) with an operating partner. The commingled fund typically has a large number of investors. The general partner or investment manager has the discretion to purchase, finance, manage and sell a portfolio of properties that it selects at its discretion, according to some fairly broad investment criteria. The general partner customarily receives a management fee of up to 2%, and carried interest distributions of 20% of profits after the investors receive some preferred return.

In contrast, a real estate JV usually consists of a single "money" partner and an operating partner, and invests only in properties that have been pre-approved by the money partner. The money partner also has veto rights over financings, business plans, dispositions and other major decisions. The operating partner often puts in a larger percentage of the capital than in the commingled fund context, and management fees and performance compensation vary considerably.

Over the past few years, larger institutional investors have been seeking alternatives to the traditional commingled fund model. Large investors are placing larger amounts of capital with a smaller number of real estate managers, and in exchange are looking for more customized products from their managers. These investors want more tailored investment strategies with more input on asset management decisions. They also seek more flexible (usually lower) pricing and larger co-investments from their managers. The large investors see the value of diversification that a pure JV does not provide, but want greater control than a fund. They may also not want to be part of a vehicle with a large number of smaller investors, who were selected by the manager without their input. Instead, these investors want to invest alongside a small number of other "like-minded" investors who are committing substantial amounts of capital.

As a result, "club deals" are becoming a much more prevalent vehicle for real estate investing. Club deals are in essence a hybrid that combines many of the benefits of a commingled fund and a JV. Clubs typically contain a handful (for example, two to four) of sophisticated, similarly situated, institutional investors who are funding larger amounts of capital ($50mn-$100mn or greater). Each club investor is able to invest in a much broader set of deals, or larger deals, than if it had invested solely in a JV with the manager. From the manager's perspective, a club deal can allow it to attract more capital than it could from a single JV partner without much of the work involved in raising a commingled fund from a widely dispersed network of target investors.

Club deals often invest in a pre-identified portfolio of assets. When capital is available for additional investments, the manager may have discretion "in a box", with much more detailed parameters than a commingled fund. In other cases, the manager has no discretion to make new investments without the consent of the club investors. One possible variation on this is to allow a consenting investor to "opt-in" (or not) to an investment and invest separately through a side vehicle.

After a property is acquired, similar to a JV, financings, business plans, dispositions and other major decisions by clubs are typically subject to the approval of the investors. One tricky area of negotiations is whether it is possible for some majority of the investors to drag other investors along in a decision. The manager obviously would prefer to not have its decisions subject to the veto right of a single investor. On the other hand, club investors are often reluctant to give up these rights. While club investors may be similarly situated, they still may have differences of opinion, which can make it more difficult to arrive at a course of action than with a fund or JV vehicle. Dispositions, buy-sells and other exit mechanisms are another area that can sometimes be more complicated to structure for a club.

Club deals can be an effective way of deploying a large amount of capital in a diversified portfolio while giving large institutional investors the enhanced discretion they desire. However, clubs require a greater degree of trust, between the manager and the investors, and within the investor group. Finding a group of truly like-minded investors is critical to a successful club investment.

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Matthew Posthuma is a real estate funds partner, and **Walter McCabe** is a real estate transactions partner, at Ropes & Gray LLP.

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