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Use of waterfall distributions in U.S. private equity real estate investments

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There are a variety of ways in which industrial and multitenant commercial development projects are financed in the United States. One common form of financing is private equity real estate investment, which typically involve as key players a senior institutional lender, possibly a subordinated mezzanine debt lender, as well as a general partner and several limited partner private equity investors. The role of the general partner is to devote the necessary time, effort, and expertise to assure the success of the project, while the role of the limited partner investors is to provide the necessary investment of capital. Given the respective roles of the general partner and the limited partner investors, performance based so-called waterfall distribution structures should be considered in allocating payments for the return of the capital invested and the distribution of profits among the partners. This model can be used in situations involving domestic or foreign equity investors.

The waterfall distribution model envisions a series of receptacles into which the funds for the return of the initial investment and distribution of profits flow downwardly once a designated rate of return is exceeded at the top tier and at each lower tier, respectively. As each lower tier is reached, the split of funds between the general partner and the limited partners changes.

A waterfall distribution model can vary substantially in structure and complexity from project to project depending on the needs and expectations of the private equity investors. Detailed provisions must be included in the limited partnership's governing documents to address the distribution rules taking into account aspects such as the order in which the general partner and the limited partners are repaid their initial investment and their corresponding share of profits ("preferred return"), the rate of return ("hurdle") that must be exceeded at each tier before funds can flow to the next tier hurdle, and how the rate of return for the hurdles will be measured (i.e. based on the percentage of interest earned on the investment over the entire holding period, the internal rate of return ("IRR"), or an equity multiple ratio calculated by dividing the sum of the equity investment, plus all profits, by the total amount of equity invested). Either the IRR method or the equity multiple ratio method of measurement of the rate of return hurdle is typically used in commercial real estate investments that are held over long periods of time.

As relates specifically to the order in which the general partner and the limited partners are paid, waterfall distribution models can be structured as simple splits between the limited partners and the general partner, which are made subject to two typical provisions which should be considered, catch-up provisions and look-back provisions.

A catch-up provision provides that the limited partners must receive one hundred percent of the project's preferred return until the designated rate of return has been achieved, at which time funds would flow to the general partner until such time as the general partner has received the rate of return specified in the partnership agreement.

A look-back provision provides that if the designated IRR is exceeded in a given year, the split would be modified such that the general partner's percentage share increases, with the limited partners still getting a better return than initially contemplated. On the other hand, for example, if looking back over the entire holding period the limited partners did not get the designated rate of return, the general partner would have to return a such portion of the profits to the limited partners as would allow them to achieve their designated rate of return.

By way of example, a waterfall distribution model for a real estate development project might include four tiers: Tier 1 with one hundred percent of the available distributions going to the limited partners; Tier 2 with a preferred hurdle rate of return with the available distributions going to the limited partners until the preferred rate of return is achieved; Tier 3 with the available distributions going to the general partner until the general partner receives its designated percentage of profits pursuant to a catch-up provision; and Tier 4 whereby the general partner receives a disproportionate share of the profits if the investment performs better than expected pursuant to a look back provision.

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