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Private equity firms and developers together again – with a twist

The two parties increasingly join forces to up ante on real estate investments

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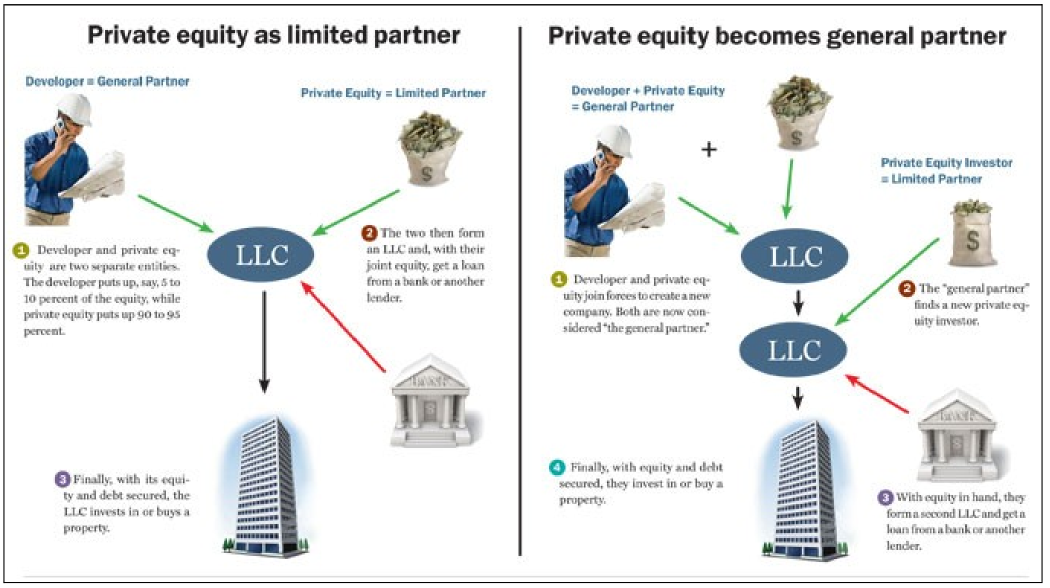

Double-dip fears notwithstanding, the real estate industry is seeing a resurgence of private equity investment. But this time around, firms who got burned during the financial crisis are taking a different tack.

Instead of doing deals on a one-off basis, with a different developer on each deal, a growing number of private equity funds are forming exclusive agreements with experienced developers through new, independent real estate operating companies in New York City and elsewhere. In an environment where many see enormous potential for growth, these investments give private equity players a leg up on the competition, and a chance to share in higher profits (known as the "promote") if the project succeeds.

Deals structured in this way are not new; in 2003, for example, the now-defunct developer Clarett Group and Prudential Real Estate Investors formed Clarett Capital LLC, a real estate development company.

But more and more private equity firms are now investing at the general-partner level, according to Manhattan attorney Steven Koppel, a partner at Jones Day who focuses on real estate private equity.

"I've seen more and more of it in the last year," Koppel said. "I'm currently handling four such deals."

For developers -- especially those whose reputations survived the downturn -- the partnerships offer a fresh start after several bruising years. For private equity firms, they save time and offer reassurance in a difficult market.

"This is a different age, a different era that we're in," said Daniel Alpert, a managing partner at the Manhattan-based real estate investment bank Westwood Capital. "You need not only people who can bring you a deal, but also quality operators, people who can go out and do successful transactions with you.

Because of that mentality, he added, "it makes sense for a lot of private equity funds and other investors to turn to exclusive arrangements [with developers]."

Investing in the G.P.

The current uptick in general-partner investing stems from today's unique market conditions.

As private equity firms became increasingly common over the past 15 years, most invested in real estate as limited partners, Koppel explained. Often, that meant contributing as much as 90 or 95 percent of the equity in the deal, while the developer -- or general partner -- put in the rest.

Then, once the project began to make money and both the limited and general partners had gotten their investment back, the developer would receive a "promoted interest," or increasingly larger share of the proceeds, often up to 50 percent, despite a comparatively small initial investment.

The promote is seen as a type of reward to the developer for his sweat equity and an incentive to strive for higher returns. But in recent years, "private equity funds saw that they were leaving money on the table, because the operating partner was getting this disproportionate return on its investment," Koppel said.

That is now beginning to change.

"What some private equity funds have been doing is, rather than being a limited partner on a project-by-project basis, they are joining forces with [that developer] and investing at the general partner level," said Koppel. The two entities then form a new operating company, which in turn seeks limited partner capital for its projects.

A prime example is Berkshire Realty Ventures, an offshoot of 40-year-old Boston real estate company the Berkshire Group. A little over a year ago, Berkshire hired Larry Ellman, Citi Property Investors' former head of North American investments, to start Manhattan-based BRV.

The venture is "focused on investing in the operating companies themselves, as opposed to buying the assets," Ellman told *The Real Deal*.

For example, BRV partnered with Chicago-based hotel company Lodging Capital Partners in late 2010. The two formed a new company, LCP Berkshire, which plans to invest $500 million to $1 billion in hotels over the next two years -- as well as seeking limited-partner capital -- to acquire properties priced between $20 million and $50 million, Ellman said.

In March, the new entity paid $35.5 million to buy the underperforming 447-room Hilton Rye Town in Westchester from Ashford Hospitality. A large private equity fund is the capital partner in the deal, Ellman said. The plan is to renovate the hotel -- which has had several different owners over the past decade -- and regain lost market share.

Founded in 2005, Lodging Capital Partners has since purchased over $4 billion worth of real estate, including the Drake Hotel in Chicago, the Four Seasons Austin, and the Snake River Lodge & Spa in Jackson Hole, Wyo. As the hard-hit hotel industry began to see more properties change hands, Lodging Capital Partners was anxious to get into the market, but needed capital, Ellman said, adding: "It was good timing for both parties." BRV is the majority shareholder in LCP Berkshire, Ellman explained, and within the company there is a promote structure in favor of Lodging Capital Partners. Still, the arrangement is better for BRV than the traditional structure, because the new venture will benefit from promoted returns on each individual deal.

The partnership came about because Ellman had a preexisting relationship and "a level of confidence" in the Lodging Capital Partners principals, from doing deals with them in the past, Ellman said.

After watching development deals sour in the downturn, investors are far more focused on the developers' experience than they were in the past, Alpert said.

"In an environment where all boats are being floated, it doesn't really matter who brings you the deal," Alpert said of the mid-2000s boom. "But in an environment that's considerably trickier, there's a premium put on the expertise of the general partner."

Once private equity funds find partners they trust, they tend to want to stick with them.

"These hedge funds like the idea of doing multiple projects with people they like, so they don't have to reinvent the wheel every time they invest," noted Eric Anton, an executive managing director and principal at Eastern Consolidated.

Meanwhile, there are a number of operators like LCP in the current marketplace, according to Ellman. He said he is looking to partner with developers in other sectors, including senior housing, retail, office buildings and ground-up residential development, on projects in Manhattan and other markets.

"There are a lot of great young operating teams out there [who] need some capital to support their platform, and also need capital for acquisitions for growth," Ellman said.

One reason is that "during the crash, you had a lot of companies that overleveraged, and some have basically split up," he said. "These talented teams are available and looking for capital to get going with a new operating business."

At the same time, he said, other sources of funding once available to developers have disappeared. "You have very good operators who had high-net-worth investors or 'friends and family' providing their general-partner capital, and there are situations where those capital sources have dried up," he said.

Starting over

For developers, even the best of whom have had a rough couple of years, a new venture with a private equity firm can mean a fresh start.

For example, Dallas-based Trammell Crow Residential has for years been one of the country's largest builders of multifamily units. But like many companies of its ilk, the 40-year-old merchant builder fell on hard times as home sales plummeted in the recession. Used to building and selling its properties quickly, the company found itself with some 20,000 apartments on its books by the end of 2010s first quarter.

Faced with this difficult scenario, CEO Charles Brindell Jr. -- who took the reins of the company from Ron Terwilliger in 2009 -- made a surprising move.

In August 2010, he partnered with real estate investment firm Rockwood Capital, based in White Plains, N.Y., to form a new company called Mill Creek Residential Trust. Trammell Crow still exists, managing its portfolio of some 20,000 apartments, but Brindell explained that he and other top executives are no longer at the company.

Seeded with some $200 million from Rockwood and Trammell Crow, Mill Creek has started construction on five new rental apartment communities, and plans to build 3,000 apartments by the end of the year. One of those projects is in West Hempstead, Long Island, where Mill Creek purchased the run-down Courtesy Hotel and plans to build a four-story, 150-unit rental apartment complex on the site, Brindell said.

"We needed liquidity to pursue new business," Brindell said of Mill Creek's formation. But potential investors in their projects "wanted to invest in a very clean balance sheet, with no existing assets or liabilities. The banks were requiring the same thing for us."

These days, Westwood's Alpert noted, investors shy away from developers already juggling large amounts of inventory. "People who are sitting on problems are considered way less attractive," he said.

So new entity-level ventures can mean a new start for real estate professionals, especially industry veterans who "want to strike out on their own but need sufficient capital to start an organization," Koppel said.