A PREDICTION FOR THE FUTURE OF PUBLIC LIMITED PARTNERSHIPS:

DEVELOPMENT EQUITY SYNDICATIONS WILL BECOME THE NEXT
WAVE OF OFFERINGS PRESENTED TO THE PUBLIC

by

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A.B., Government
Dartmouth College
Hanover, New Hampshire
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Submitted to the Department of Architecture
in Partial Fulfillment of the
Requirements of the Degree in the
Master of Science in Real Estate Development

at the

Massachusetts Institute of Technology

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ABSTRACT

This paper creates a conceptual framework for understanding limited partnership interests in real estate as securities and how such interests relate to the underlying assets. The measure of testing this framework focuses on the cash returns to the investor. The question is whether higher returns can be achieved by forming limited partnerships for the purpose of securitizing more risky asset plays, e.g., the development equity syndication. Information for testing the framework comes from a selected groups of existing publicly-registered limited partnerships.

The results indicate that the estimated yields from three partnerships formed for land development, a riskier asset play, are very close to the yields of three partnerships investing in existing properties. This runs contrary to the expected result of higher yields for higher risk. Despite these findings, the proven performance of one asset manager's portfolio of development properties shows that higher yields can be achieved through higher risk real estate assets. The thesis suggests that syndicators will become more active in forming limited partnerships to invest in these kinds of real estate assets in an attempt to provide higher cash yields to investors.

Thesis Supervisor: Lynne B. Sagalyn
Title: Associate Professor
ACKNOWLEDGEMENTS

This thesis represents the culmination of my year at the Center for Real Estate Development. While it is too early to measure what I have learned, I am positive that it will have a long lasting impact on the future of my career in real estate development. Therefore, the first acknowledgement goes to the faculty and staff of the Center for their dedication and personal attention towards all of the students. Second, I thank my business partner, Kermit Bartlett, for understanding my need to go back to school for the year. And finally, I thank my parents for all their support and devotion over the years.

While all of these thanks are deserved, they represent an acknowledgement of help and support during the broader course of the year. For this thesis, my first thanks go to my advisor, Lynne Sagalyn, for focusing my research and keeping me on track. I know I could not have done this thesis without her constant attention and critical revisions to each draft. Second, I must thank all of the individuals in various syndication firms and industry groups with whom I talked. Special thanks go to Mr. Fuhrman Nettles of the Robert A. Stanger Company. Without his help, a large part of this thesis would not be possible.
Background of the Author

Kenneth A. Elias graduated from Dartmouth College in 1982 with an A.B. in Government. He founded and continues to work for a syndication firm which specializes in developing and selling products to high net-worth individuals. His area of expertise focuses on the creation of development equity syndications. Previous work experience includes positions as an acquisition analyst for American Residential Properties, a major private syndicator of tax-shelter partnerships, and as an associate consultant for Robert Charles Lesser & Company, a nationwide real estate consulting firm.
# TABLE OF CONTENTS

Abstract .................................................... 2  
Acknowledgements ............................................ 3  
Background of Author ........................................ 4  
List of Exhibits ............................................. 6  

Chapter One: Introduction  
A. Purpose ................................................ 7  
B. Data Sources .......................................... 9  
C. Thesis Structure ...................................... 11  
D. History of Syndication ............................... 13  

Chapter Two: Understanding Limited Partnership Interests As Securities  
A. The Real Estate Development Industry, Risk, and Value Creation ................. 16  
B. Real Estate Securities and Syndication .......... 20  
C. Real Estate Syndications as Limited Partnerships ........................... 27  

Chapter Three: The Development Cycle and Real Estate Returns  
A. Looking at the Risk Continuum ...................... 30  
B. Review of Selected Literature Examining Investment Performance of Real Estate Limited Partnerships .......................... 32  
C. Model for Evaluating Risk/Return Structures .. 37  

Chapter Four: The Market for Real Estate Limited Partnerships  
A. Investment Market Segments ......................... 43  
B. Real Estate Products and Investor Preferences .53  
C. Sponsor Types ......................................... 58  

Chapter Five: Examining the Historical Performance Record  
A. Examining the Returns ............................... 67  
B. Review of Selected Partnership Returns ............. 71  

Chapter Six: The Development Equity Syndication  
A. The Copley Experience ............................... 83  
B. Explaining the Development Equity Syndication .88  

End Notes ................................................... 100  
Selected Bibliography ...................................... 102
| Exhibit 1: | Process and Value Creation in Real Estate Development | 18 |
| Exhibit 2: | Differences Between the Limited Partnership Partnership Interest and the Corporate Stock Certificate | 25 |
| Exhibit 3: | Comparison of Returns Under Different Evaluation Criteria | 41 |
| Exhibit 4: | Real Estate Fund Sales Since 1970 | 44 |
| Exhibit 5: | Publicly Registered Equity RELP Sales by Amount of Leverage: 1982 - 1987 | 52 |
| Exhibit 6: | Composition by Property Type for Publicly Registered Offerings: 1981 - 1987 | 54 |
| Exhibit 7: | Public Equity Partnerships by Real Estate Activity: 1983 - 1988 | 59 |
| Exhibit 8: | Comparison of Relative Sponsor Compensation Load: 1985 versus 1988 | 60 |
| Exhibit 10: | Performance Results of Selected Angeles Corporation Partnerships | 74 |
| Exhibit 11: | Performance Results of Selected Centennial Partnerships | 78 |
A. Purpose

Development equity syndications will become a more significant type of syndication offering to the investing public in the near future. The Tax Reform Act of 1986 (TRA 86) eliminated many of the tax benefits of investing in real estate which resulted in an immediate decline in the sales of real estate limited partnerships (RELPs). Going forward, the most important component of return to investors will be the true economic returns, that is cash distributions, from such partnerships. With renewed interest in cash distributions by investors, RELPs that provide higher returns than other kinds of security interests should sell in the market. The development equity syndication, while riskier than an equity syndication of existing property, offers the potential to achieve these higher returns. To understand this new stage of the syndication market, an examination and understanding of this market will be detailed. Subsequently, information will
be presented which will support this argument.

Syndication provides a means for the flow of capital from suppliers of capital -- investors -- to those in demand of capital -- developers, property sellers, and others who utilize capital for productive purposes. Interests in RELPs represent the securitization of an asset or group of assets easily acquired by investors seeking such investment. These securities should offer a return comparable to the degree of risk associated with the underlying asset and the risk inherent in the security. In many ways, RELPs differ from other types of securities due to both the nature of the security and the asset represented by such securities. RELPs do not offer liquidity, and the extent to which the asset can increase or decrease in value often becomes subject to localized market forces which cannot be influenced by any such management action. Understanding the differences between a partnership interest and other securities is relevant to understanding how such securities perform in terms of return to the investor. However, the more interesting question addressed by this thesis focuses on the differences within real estate assets themselves and how investor returns might be expected to differ given the underlying nature of the asset. First, the framework for thinking about how returns from real estate at different stages of the development cycle might vary will be examined. Second,
an exploration of the actual performance from RELPs organized for two stages of the development process -- land development and acquisition of operating properties -- is compared against the framework of expected returns. Keeping this framework in mind, the thesis presents an explanation of the development equity syndication and the results for one large investor in this kind of real estate security.

Because real estate syndication activities raised more than $29 billion dollars over the past five years, it cannot be ignored as a provider of capital to the real estate industry. While part of the attractiveness in prior years resulted from the benefits of tax shelter, not all deals depended on such tax shelter for their existence. If the industry is to remain an active provider of capital, the investor will need to be compensated accordingly to make such RELPs attractive. This attraction, I maintain, may come from the promotion of RELPs securitizing more risky asset plays.

B. Data Sources

Making a prediction and proving it based on factual data can be a daunting task, especially given the broad nature of the marketplace and the difficulty categorizing all of the components into neat boxes. Instead, the research done for
this thesis begins with a look at the broader aspects of the industry and makes a series of assumptions thereby narrowing the level of scrutiny to a more manageable level.

To research the market for syndication investments, data came from a number of sources, primarily information on offerings published by the Robert A. Stanger Company, a firm specializing in tracking this industry. Qualitative information came from a number of other groups close to the industry, especially the Real Estate Securities and Syndication Institute (RESSI) and from the National Investment Partnership as well as from other researchers studying this field.

Specific information on actual performance data presented the most difficult aspect of data collection. The private placement sector of the industry, the largest fund raiser until 1987, cannot be tracked in detail as federal securities laws do not require extensive disclosure through the Securities and Exchange Commission (SEC), and no central clearinghouse of information exists for this group. RELPs offered to the broader public must pass through the SEC and this results in a greater level of data on this sector. Performance data for existing public RELPs is drawn from published information included in current offerings by RELP sponsors. Sponsors are required by SEC guidelines to include prior performance data
in current public offerings.

C. Thesis Structure

This first chapter sets the stage for understanding the orientation of this paper towards the syndication segment of the real estate securities market. It finishes with a brief history of the syndication industry since the end of World War II. The second chapter begins with a discussion of the creation of product in the real estate industry. It lays out the degrees of risk and return across the spectrum of product in this industry. Next, this chapter looks at the real estate security and compares RELPs to other real estate securities. A specific understanding of the limited partnership as an investment vehicle is then presented.

Developing a strategy for thinking about the securitization of the real estate limited partnership offerings is the theme of the third chapter. First, a brief review of thinking about the returns from real estate and RELPs in particular is presented. The second part of this chapter creates a framework for thinking about the returns from RELPs whose underlying assets cover the range of product created throughout the development cycle.
Chapter Four examines the market for real estate limited partnerships with a look at the marketing orientation and product types available to investors over the course of the past 10 years or so. A look at issues that are not asset specific forms the first section of this chapter. Tax-shelter partnerships are not reviewed due to their relative brief history (1981-1985) and the near-elimination of these deals as a result of the Tax Reform Act of 1986. This chapter also examines sponsors of real estate limited partnerships.

In the fifth chapter, the returns of deals structured by two syndicators are examined. The objective is to evaluate whether the expectations about the risk/return investment relationship made in the preceding chapters conform to actual performance data.

Looking at development syndication becomes the centerpiece of the sixth chapter. First, the chapter reviews of the experience of one sponsor in development joint ventures. Second, the chapter explores some questions regarding this form of RELP. What considerations become important in organizing and managing these RELPs? To what extent are they an element in the syndication marketplace and how will this change in the future? How are these syndication deals different from other RELPs and how do the returns differ? Will
more investors seek out these deals? What role will the sponsor play? Last, some predictions are made regarding investor interest in this form of RELP.

D. History of Syndication

While the real estate syndication industry got its start in the years following World War II, the industry's infancy developed in the 1960's. The RELP as an investment medium became better understood and more widely available to the broader investment community. In the early 1970s, the industry grew tremendously with many inexperienced sponsors joining the investment fray. The general recession of 1974-1975 forced an industry shakeout and resulted in a consolidation of the market among six sponsors -- Consolidated Capital, Balcor, Integrated Resources, JMB Realty, Robert M. McNeil, and Fox & Carskadon. By 1980, these firms were selling more than 50% of the total public product by 1980.

The growth of syndication in the late 1970s occurred for several reasons. First, rapid inflation combined with the relatively poor performance of the stock and bond market attracted investors to real estate. Second, the 1976 Tax Reform Act and Revenue Act of 1978 imposed "at-risk" limitations on most other tax shelter investment programs.
except real estate and thus augmented interest in real estate by tax-shelter seeking investors. Finally, the actual price performance of real estate, especially housing prices, fueled interest in the ownership of real estate assets, both as direct investment and through securities, propelled the interest in RELPs.

In the 1980s, the market exploded with sales of public RELPs (those which are registered with the SEC) increasing in every year until 1987. Part of this explosion resulted from the additional tax sheltering benefits provided to real estate due to the passage of the Economic Recovery Tax Act of 1981 (ERTA 81). While tax shelter worked its way into public deals as a component of returns, private RELP (those partnerships not required to register with the SEC) sales zoomed as sponsors found tremendous demand by high-net worth individuals for generous tax shelters created through highly leveraged acquisitions. (The private RELPs could be structured more flexibly than public deals to take greater advantage of tax shelter benefits.) As the market grew, the number of sponsors increased as well. The TRA of 1986 eliminated many of the sheltering devices of previous years and forced another shakeout in the industry. One author estimates that 25% to 30% of the syndication firms existing in the early 1980s disappeared as a result. 2/ While many expect that the private
RELP market will remain dormant for the next several years, the public RELP market will continue to survive, albeit in a smaller form from the mid-1980s, by offering an array of products to meet different investor objectives.
A. The Real Estate Development Industry, Risk, and Value Creation

The real estate development industry comprises a broad range of activities which relate to the development, construction, and management of land and buildings. In particular, the value realized from the creation or ownership of the real estate asset, a building or land, attracts the investor. The product, whether developed or purchased, requires a great deal of capital. It is the developer's need for capital combined with the investor's desire to own such assets which defines the role of the syndicator. As a financial intermediary, the syndicator brings together the asset with the investor's capital and structures a security which represents the investor's interest in some portion of the asset. Before looking at the security itself, an understanding of the value and risk in real estate development products needs explanation.
The real estate industry, like any other business, is fraught with risk. Risk can best be defined as the degree of variability of achieving an expected rate of return. The most common types of risk relevant to the industry are the following: (1) business risk -- the risk of achieving expected net income or capital gain because of changes in the real estate marketplace, regulatory processes; (2) financial risk -- the risk of default on borrowed funds; and (3) inflation risk -- the risk of losses in real value due to nominal changes in price of goods and services. These risks vary in magnitude depending upon the stage of the development cycle. Plus, the degree to which such risks can be mitigated impacts the investor's potential for reward or failure. An examination of the development process helps to explain some of these risks.

EXHIBIT 1 presents the general steps of the development process involved with the creation of asset value. The process begins with raw land acquisition and ends with a finished building rented to tenants or held for sale. While this exhibit outlines the development process from start to finish in an abbreviated form, it is not necessary that all steps of the process be followed by a single firm or individual. One can enter or depart at any stage provided that a market exists for the good to be acquired or sold.
EXHIBIT 2

DIFFERENCES BETWEEN THE LIMITED PARTNERSHIP INTEREST
AND
THE CORPORATE STOCK CERTIFICATE

<table>
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<tr>
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<td><strong>Form of Returns</strong></td>
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While the exhibit shows the steps involved, the risks associated with completing each step cannot be easily quantified. One way to think about the overall development risk is to examine the relative distance each step in the process goes towards bringing a project closer to its self-supporting mode -- a leased or sold project. What must be done to bring each step along to this project? What risks exist in completing each stage successfully?

Raw land has no value other than what someone is willing to pay for it. By itself, it provides the owner with a negative return during any holding period due to the annual expenditures necessary to retain ownership (e.g., property taxes, debt service, etc.). Once the land is improved (developed), one holds an asset much closer to the end result and has completed one step in the overall development process. This by itself creates value in the land. As one moves along in the process, one draws closer to the bricks-and-mortar product which produces operating revenues needed to generate an investment return and pay back the development costs.

This model of value creation and risk works only for development created in a vacuum. Market forces impact value, both positively and negatively, over time. As a result, the changes in risk in each step of the development process do not
occur linearly because the environment in which development occurs changes. Certainly, the risk in any one stage may change as market forces impact value. Therefore, it may not always be true that greater value can always be created the closer one comes to the operating property. Even so, this simple model explains the process in a way that is useful for investors. For different real estate products, it is possible to create investments with different levels of risk for all parties: developer, investor, and syndicator. Obviously, the least risky product would be structured based on the acquisition of a fully-leased property. In order to see how the syndication industry can create different investments from different real estate products, one must understand the nature of a syndication.

B. Real Estate Securities and Syndication

The Securities Act and the Securities Exchange Act of 1934 mention three concepts in defining a security: "certificate of interest or participation in any profit-sharing agreement"; "investment contract", and; "instruments commonly known as a 'security'." The test for determining if a security exists within these three concepts comes from a judicial interpretation in United Housing Foundation v. Forman, 421 U.S.
which states that a security exists if there is "an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others." Limited partnerships interests thus become securities as the limited partner invests monies with the intention of receiving financial returns without his involvement in the management or investment of such monies. 

Why securitize real estate? It allows for the investment of funds with a reasonable expectation of return without the requirement of management by such investors. Funds can thus be aggregated from investors by those who provide the managerial effort, the developer for example, to generate a return thereon. From the investor's perspective, the security does the following: 1) it allows for the investor to pool his resources with those of others to invest in something he may not have the management capabilities, resources, or time to do by himself; 2) it limits the risk of his exposure to the value of the security itself and not to the broader risks of the activity; and 3) it allows him to value the security independent of the underlying activity and sell the security if a buyer can be found. For the user of capital, the developer in the real estate industry, the issuance of securities provides for the following: 1) assembly of capital necessary to
provide an activity; 2) selling of an equity interest in an asset to others while maintaining managerial control; and 3) mitigation of risk by reducing his own capital investment.

Real estate securities come in several forms. For the real estate syndication industry, the limited partnership interest serves as the security. Other forms include the Real Estate Investment Trust (REIT), the Master Limited Partnership (MLP), the common stock of real estate companies, the Commingled Real Estate Fund (CREF), and various forms of securitized debt instruments collateralized by real estate mortgages.

All of these securities share the same characteristic in that they aggregate investor funds for investment in some activity related to real estate. RELPs differ from the other forms of real estate securities, though. First, the RELP is a limited partnership and exists under statutes created in each state and is governed under such laws. In general, a limited partnership can engage in any legitimate activity. Second, for federal tax purposes, it is not taxed as an entity; all income and losses of the limited partnership pass through the partnership entity directly to the partners. Third, the limited partner's liability is restricted to his partnership investment provided the limited partner does not engage in the management of the partnership.
MLPs provide similar benefits as limited partnerships, plus the partnership interests usually are listed on a securities exchange. (There are restrictions on the activities of the MLP to avoid taxation at the partnership level.) REITs cannot actively manage their real estate assets and must distribute a specified percentage of taxable income. CREFs are generally oriented towards the larger pension fund investor and are not marketed to the broader investing public.

Syndication is not a new idea. Identifying the beginning of the concept of pooling investor resources cannot be ascertained, but it was used as early as the 1920s to finance many downtown highrises of that era. In its most general form as the assemblage of capital resources for the purpose of making an investment, then, any other method of assembling capital for the purpose of making an investment could be termed a syndication. The stock market, a liquid capital market, essentially provides the same aggregation function without intermediaries by allowing many individuals to own corporate equity collectively. Corporations seek equity capital by issuing shares of stock using capital from investors to pursue corporate goals. The success with which a corporation achieves its corporate goals, increases its earnings and net assets, reflects in changes in its stock price. Corporations also pay
dividends to stockholders which, in some cases, come from the retained earnings. Yet, such dividends do not provide the sole reason for holding stock. Investors also seek capital appreciation through the rise in the stock's price. What sets the syndication market apart from the stock market is the form of ownership of the security held by the investor. Both are equities, but in the corporation, the ownership takes the form of the stock share certificate; in the syndication, ownership takes the form of the limited partnership unit interest.

The distinctions between the corporate stock share and the limited partnership unit interest are shown in EXHIBIT 2. While this list is not definitive, it highlights the key differences between the two forms of securities. The most important difference relates to the method of taxation. As a result of federal legislation, taxation occurs at the individual level in the partnership, not at the corporate or partnership level. Corporations pay taxes at the corporate level and individuals pay taxes on any dividends received. Therefore, partnerships act as conduits by passing through any income, gains, or losses. Ideally, cash distribution in a
## Differences Between the Limited Partnership Interest and the Corporate Stock Certificate

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partnership will at least cover the tax payment required by the individual investor. To the extent that the income of the partnership can be sheltered through non-cash expenses, especially depreciation, the partnership can shelter a portion or all of its cash earnings from taxation. For this reason, asset ownership of existing property through the limited partnership security makes sense as the preferred investment vehicle. (It should also be noted that the benefits of the investment can be more flexibly structured in the limited partnership. Cash distributions, tax losses and income, and capital gains can be segregated as separate benefits. As a result of the TRA of 1986, there are several tests in determining whether such allocations are tax abusive. If so, the tax code now forces a reallocation of such benefits to bring them in line with the economic effect of such allocations.)

Of course, investor interest in a security depends upon other characteristics other than merely the form of the security. Achieving a suitable return from the security, all things considered, must be an element in any investment decision. To what extent does risk play as part of the underlying investment? Is the investor compensated accordingly for taking greater levels of risk? Does the time horizon of realizing the return impact the value or return necessary from
such security? Liquidity of a security also must play a role in determining value. Since no secondary market exists for RELPs, how do RELP's returns offset the illiquidity of the security?

C. Real Estate Syndications as Limited Partnerships

Generally, real estate assets are not held collectively through stock ownership. Group ownership of income-producing real estate assets is best accomplished through the partnership form. While the limited partnership can raise upwards of hundreds of millions of dollars, most RELPs remain small in terms of total dollars sought and number of units outstanding. Out of the 143 public offerings active in May, 1988, 121 (85%) desired to raise $50 million or less exclusive of greenshoes. (Greenshoe is an industry term for the general partner's option to increase the size of the offering by some fixed amount depending on market demand.) When purchased in unit sizes of $1,000, the number of units available to trade becomes limited. More important though, most public RELPs do not become fully invested until several years after partnership formation. This results from the time lag to raise all of the funds and to acquire properties or other assets. If such partnerships could issue "stock" that traded immediately, the "stock" would trade at a significant discount given the lack of current earnings
and uncertainty as to future performance.

The partnership form of the security makes more sense for real estate assets because there is no need to retain earnings at the partnership level. The RELP acquires assets with either equity or debt or some combination thereof. Once invested, all earnings of the partnership can be distributed to the investors; there is no need to increase or augment the net worth at the partnership level to pursue additional activities or increase the size of the RELP's assets. RELPs with operating properties can be depreciated (even if it is not truly reflective of the economic depreciation of the underlying asset), and this non-cash expense can shelter income of the partnership from taxes. This benefit can best be used at the individual level in which the investor can take in cash which is sheltered to some extent from taxation until the depreciation runs out.

RELPs come in many forms. They differ in product type, structure of balance sheet, offering terms, and expected returns to the investors. Most RELPs have been set up with the acquisition of operating properties as the principle objective. The flexibility of the RELP form does not limit the purpose of investment activity. Also, RELPs can develop land, develop buildings, rehabilitate existing structures, and invest as
mortgagees to real property. The realm of possible activities defies categorization. Chapter Four best describes the state of the market for RELPs.
A. Looking at the Risk Continuum

As explained in the previous chapter, the creation of real estate product through the development cycle contains many stages, each with varying degrees of risk. Certain risks are uniform across product types, however, like lease-up or sales risk and construction cost risk. To understand these risks and their impact on returns, concepts from the available literature are discussed.

The reward for taking on greater levels of risk should be greater levels of return. Risk measures the variability of cash flow (or some other measure of return) from an expected rate of return. A U.S. Government security represents the lease risky of possible investments based on a variability of cash return. The cash flows received each year would be consistent and predictable. This return would be considered the risk-free rate. (This is not to say one does not take on other kinds of risk in purchasing such a security, especially
the erosion in the real value of the return due to inflation or
the vagaries of the net value received if sold before
maturity.) Purchasing any other security in which the return is
not predictable, one should be compensated by a higher expected
return. Therefore, the expected return which exceeds the
risk-free rate for the same government security of the same
maturity can be termed as the risk premium return.

Investment in real estate securities must, therefore, have
a risk premium return due to the uncertainty of their cash
flows. Yet, the degree of uncertainty varies depending upon
the nature of the real estate collateralizing the security.
Acquiring a real estate security representing an interest in a
fully-leased, completed property has a different degree of
uncertainty than a security which represents an interest in a
development property not yet under construction. The expected
cash flow returns from these two different types of properties
certainly must have a considerable spread as measured by the
difference in the risk premium. One can calculate and
reasonably forecast with greater certainty, at least in the
short term, the returns from the fully-leased property, while
the return from the development property is more uncertain.

Furthermore, each stage of the real estate development
process should have a different risk premium. As one moves
farther from the completed development stage back towards the raw land stage, the risk premium should increase correspondingly. Land development should show the highest risk premium. Ideally then, a portfolio of real estate securities can be tailored to meet differing degrees of risk acceptability.

What will be the marginal increase in risk premium for securities representing different stages in the development process? Can these differences be quantified? What do most investors expect?

B. Review of Selected Literature Examining Investment Performance of RELPs

Most articles examining the returns to investors in RELPs only look at those partnerships which invest in properties at the final stage of the development process -- the completed and leased building. Given that the bulk of the RELP industry invests in existing properties, this research effort is not surprising. While the amount of literature is not extensive, the conclusion reached by most researchers seems to indicate that the returns, on a pre-tax basis, have not been very good. A review of the thinking on real estate returns and returns from RELPs follows.
In 1976, Stephen Roulac, a noted researcher of the real estate security industry, compared the returns of real estate, in general, with those from common stock investments. He found that the returns from real estate:

on balance, considering the literature on investment returns, as well as evaluating the inherent value generating capabilities of real property, a realistic expectation as regards realized rates of return for real estate investment over time is in the 5% to 6% range. 1

In the same article, the author goes on to assert that real estate, as "a class of investments should correspond closely to the returns from the class of common stock investments." 2 The author goes on to assert that given the comparable returns of real estate with common stocks, the only benefit in investing in real estate comes from the greater predictability ... associated with real estate investment returns than common stocks. Part of this reduced risk is attributable to the basic economic pattern of real property as compared to the economic pattern of corporated enterprise, and part is attributable to the enhanced dispersion of results following from the securities form of common stocks. Since returns from the two investment classes over time will be comparable, real estate merits an important role in ... portfolios. 3

Roulac limited his focus to a homogeneous group of real estate products -- existing property already leased at the time of
investment. In one sense, this result may only be indicative of the returns for investment in this class of real estate and not for investments in real estate products created earlier in the development process.

What might investors expect from a real estate investment? According to Roulac, most investors expect rates of return well in excess of 10%. This result comes from the investment community's lack of realism about returns for real estate, often a result of the fact that accurate return data is difficult to ascertain versus stock market performance. In addition, the simplicity with which projected returns can be arranged to show higher operating performance, also contributes to the general investor naivete about expected returns.4

The article further suggests that most investors believe real estate offers superior returns for some very simple reasons:

1) Investors in risk investments expect to achieve results superior to their perceptions of the "risk free" rate;

2) Investors are naturally optimistic believing either that they possess superior expertise and/or investment conditions in the future will be better than they have been in the past;

3) Many investors are naive and lack the analytical ability and insights necessary to have an informed judgment as to what a reasonable return expectation consists of;
4) The small group of investors who do possess insight into the level of reasonable expectations, for competitive reasons, may seek to influence market perceptions of returns in order to obtain the best terms when buying or selling; and

5) The marketing pressures of seeking new investment management business and retaining existing business cause many to "oversell" the level of returns that can reasonably be achieved.

Research into the returns of RELPs to investors also indicates that returns are quite low, considerably less than the 10% expectation level. In an article published in 1985, Rogers and Owers examined the returns from 32 public partnerships formed in the 1970s which included both tax- and income-oriented offerings. They discovered that pre-tax returns to the limited partners in income-oriented partnerships (i.e., those not organized for the purpose of creating tax-shelter) were extremely low, less than 1% on a pre-tax basis in a sample of seven public syndications of the whole group. However, their analysis does not include the residual value of the property at the time the return calculation is made. Even so, this research shows that the current return to the investor in income-oriented RELPs has been quite low.

One possible explanation for the poor performance of some income-oriented partnerships may be the unreal expectations of property income made by syndicators. In another study, two researchers compared the projected returns in 1983, the year of
the offerings, with the actual returns in 1985 for 39 offerings by five different sponsors. They discovered that in four out of five cases, the projected net operating income exceeded the actual results. While not expected to correlate precisely, the actual results varied greatly, from 25% to 120% of projected values. The reason for the results stem from wide differences in both revenues and expenses from projected levels, especially on the expense side of the income stream. If anything, the results suggest a possible explanation for low current returns of many income-oriented syndications -- the expected results from operations cannot be accurately estimated by syndicators when organizing RELPs.

These findings would lead the reader to believe that investing in real estate is equivalent to investing in common stock except that one might expect a greater predictability of returns from the real estate. This finding does little to shed light upon the makeup of such real estate investments. There should be a greater expected return from a development-oriented security versus one made in an existing property given the corresponding risk profiles. The question remains what might be an acceptable level of return for securities acquired representing different stages of the development process and their inherent risk?
While real estate investors may overstate the expected returns from investment, this group does understand that risk premiums increase as one moves further back in the development process. For development projects, i.e., those requiring investment prior to project completion, investors typically look for a return on invested funds between 20% to 30% calculated as an internal rate of return (IRR). For investments in raw land development, the returns expected should be even greater, in excess of 25%, according to one land syndicator.

C. Model for Evaluating Risk/Return Structures

Based upon the previous discussion, the investment return of securities representing interests in differing stages of the real estate development process should offer increasingly higher yields. Before looking at actual performance returns, an examination of the components of the return and the method by which returns should be calculated is presented.

The basis used to analyze returns examines only actual cash invested and distributed and the timing factor which separates the investment and return. Returns can also include tax benefits but, for the purposes herein, these will be ignored. Investment in RELPs rarely provides a 100%
pass-through of funds into the acquired asset. Typically, the sponsor of the RELP claims a certain amount of the invested funds as fees for providing various services to the partnership. These fees range greatly, anywhere from 5% to 30% or more. Therefore, the invested dollars going into the underlying real estate asset are less than 100% of funds invested. Returns, however, are calculated on the total dollars invested in the partnership.

On-going cash generation becomes the source of return other than tax benefits. This results from the operation of an existing property which throws off cash, after satisfaction of the debt service, if any, which gets distributed to the investors. Such cash generation can only come from those deals in which the project reaches the last stage of the development cycle. Therefore, this component of returns will not be found for any other security created earlier in the development process. (The one exception may be the land development situation in which the land receives rent from a source, agriculture for example, prior to undergoing physical development.)

The second component of the return comes from the sale of the property asset or another capital event such as refinancing. As stated before, whereas a sale can occur
between any stage of the development cycle, other capital events, primarily refinancing, are limited to those projects in operation. In any case, capital events occur infrequently and usually signal the dissolution of the partnership. The impact of a capital event on returns is most unpredictable at the outset of a real estate investment. It would be incomplete to compare returns from RELPs without including this component return, however.

In evaluating returns, each component of return has a timing element. Cash from operations may be distributed on an annual basis whereas a capital event is, most likely, a one-time occurrence which might occur several years after the initial investment. This timing difference impacts the returns when using an IRR return measure due to the reinvestment rate problem. Instead, the method should evaluate returns above a risk-free rate. To do this, a discounted cash flow analysis is followed. Cash flows and capital events are discounted over a given period at the risk-free rate (U.S. Government Security of comparable maturity). The discounted value of this fund flow (net of the investment amount) is then divided by the initial investment amount. The result can be thought of as a risk-premium profitability index (PI) and provides a method for comparing returns of different investments which may have timing differentials between returns.
EXHIBIT 3 shows the impact of timing differences in terms of measuring returns of a $10,000 investment for hypothetical returns of a development and acquisition investment. As shown, the difference in the returns can be dramatic as in the case of the development security. The acquisition security shows that the projected return is lower when using this NPV method of calculating returns versus IRR. The value gained by using this method of calculating returns yields information as to the extent the investment exceeds the risk-free premium. If the profitability index is positive, the return on the investment exceeds the risk-free rate, and the difference between the two rates equals the profitability of the investment above the risk-free rate. As shown, the profitability of the development security exceeds a 100% return while the acquisition security only exceeds the risk-free rate by slightly more than 10%, an amount hardly making this hypothetical investment worthwhile.

In getting to a model for thinking about risk/return structures, it is fair to assert that the risk premium for RELPs offerings backed by different property characteristics should offer increasingly greater returns. Of course, this may be a slight over-simplification of real world situations.
EXHIBIT 3

COMPARISON OF RETURNS UNDER DIFFERENT EVALUATION CRITERIA

<table>
<thead>
<tr>
<th>Hypothetical Cash Streams</th>
<th>Development Security</th>
<th>Acquisition Security</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Investment</td>
<td>($10,000)</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Year 1</td>
<td>$0</td>
<td>$500</td>
</tr>
<tr>
<td>Year 2</td>
<td>$0</td>
<td>$600</td>
</tr>
<tr>
<td>Year 3</td>
<td>$25,000</td>
<td>$700</td>
</tr>
<tr>
<td>Year 4</td>
<td></td>
<td>$750</td>
</tr>
<tr>
<td>Year 5</td>
<td></td>
<td>$900</td>
</tr>
<tr>
<td>Year 6</td>
<td></td>
<td>$950</td>
</tr>
<tr>
<td>Year 7</td>
<td></td>
<td>$15,000</td>
</tr>
</tbody>
</table>

Internal Rate of Return: 

Development Security: 35.7% 
Acquisition Security: 11.4%

A. Risk-Free Rate: 

Development Security: 7.50% (3-year period) 
Acquisition Security: 9.50% (7-year period)

B. NPV of Cash Stream (at risk-free rate): 

Development Security: $10,124 
Acquisition Security: $1,081

Profitability index: 

Development Security: 1.012 
Acquisition Security: 0.108

Profitability Index calculated as follows:

1) Figure PV of positive cash flows using risk-free rate for a given maturity; 
2) Subtract original investment from PV value; and 
3) Divide result of Step 2 by original investment amount.
Certain factors can mitigate risk in any stage of the development cycle and need to be accounted for when thinking of returns. For example, a significant portion of the risk in building development -- lease-up risk -- disappears once the building becomes pre-leased. If so, this reduced risk element needs to be factored into the expected returns of the RELP. Obviously, the returns should be less due to less exposure to lease-up risk.
A. Investment Market Segments

One author estimates that the total value of commercial real estate in the United States equals $2.6 trillion of which $800 billion represents debt. This means that the remainder, or $1.8 trillion, is held as equity investment in such commercial property. Yet, in the last decade or so, the total amount of equity funds raised by syndicators both public and private amounts to little more than $60 billion since 1970 as shown in EXHIBIT 4. This suggests that the total dollars raised since 1970 represents less than three percent of the total value of commercial real estate in the U. S. today. If just public syndication of equity are considered, then the percentage of the total investment in commercial property is less than two percent. In actuality, the percentages are even lower since not all of the dollars raised by the syndicators go into the asset. One can conclude from this analysis that the
### EXHIBIT 4

REAL ESTATE FUND SALES SINCE 1970
($000,000s)

<table>
<thead>
<tr>
<th>Year</th>
<th>Public Offerings of RELPs</th>
<th>Total Public and Private RELPs</th>
<th>Total Public Market</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Highly Leveraged</td>
<td>Low Leveraged</td>
<td>Mortgage Loan</td>
</tr>
<tr>
<td>1987</td>
<td>918</td>
<td>3,874</td>
<td>1,846</td>
</tr>
<tr>
<td>1986</td>
<td>2,415</td>
<td>2,516</td>
<td>2,245</td>
</tr>
<tr>
<td>1985</td>
<td>2,322</td>
<td>2,690</td>
<td>1,902</td>
</tr>
<tr>
<td>1984</td>
<td>2,381</td>
<td>1,953</td>
<td>939</td>
</tr>
<tr>
<td>1983</td>
<td>2,550</td>
<td>921</td>
<td>875</td>
</tr>
<tr>
<td>1982</td>
<td>1,492</td>
<td>456</td>
<td>317</td>
</tr>
<tr>
<td>1981</td>
<td>1,200</td>
<td>325</td>
<td>75</td>
</tr>
<tr>
<td>1980</td>
<td>933</td>
<td>250</td>
<td>N/A</td>
</tr>
<tr>
<td>1979</td>
<td>638</td>
<td>100</td>
<td>N/A</td>
</tr>
<tr>
<td>1978</td>
<td>580</td>
<td>387</td>
<td>947</td>
</tr>
<tr>
<td>1977</td>
<td>342</td>
<td>228</td>
<td>570</td>
</tr>
<tr>
<td>1976</td>
<td>147</td>
<td>100</td>
<td>247</td>
</tr>
<tr>
<td>1975</td>
<td>(No Discrete Data for this Period)</td>
<td>87</td>
<td>58</td>
</tr>
<tr>
<td>1974</td>
<td>76</td>
<td>48</td>
<td>124</td>
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<tr>
<td>1973</td>
<td>134</td>
<td>89</td>
<td>223</td>
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<tr>
<td>1972</td>
<td>107</td>
<td>70</td>
<td>177</td>
</tr>
<tr>
<td>1971</td>
<td>68</td>
<td>45</td>
<td>113</td>
</tr>
<tr>
<td>1970</td>
<td>14</td>
<td>10</td>
<td>24</td>
</tr>
</tbody>
</table>

Total $14,849 $15,085 $8,199 $1,635 $39,323 $21,651 $60,974

**Notes:**

Highly Leveraged - Leverage for more than 50% of total asset purchase

Low Leveraged - Leverage less than or equal to 50% of total asset purchase

Mortgage Loan - RELPs organized for the purpose of making mortgages on existing properties.

In 1987, the SEC no longer required sales date on Form D thus making it difficult to estimate the size of the private syndication market going forward. It is well known within the industry that the private market suffered serious decline in sales in 1987. Some estimate that the sales for 1987 declined by more than 50% from the previous year's level.

Source: Robert A. Stanger & Co.
syndication market is not a significant factor in the overall ownership of commercial property. Its potential, though, appears tremendous.

EXHIBIT 4 also illustrates the rapid growth in the industry in the 1980s as compared with the 1970s. In part, the ERTA of 1981, with its liberal depreciation deductions and other tax-sheltering devices, helped to stimulate the interest in real estate for the individual investor according to sources familiar with the industry. In addition, the increase in interest can also be traced to the greater effort of syndicators, both public and private, to sell such benefits to the investor marketplace. Yet, with the passage of the TRA of 86, the market for such offerings declined considerably, especially within the private placement market, due to the elimination of much of the tax-shelter aspects of real estate investment.

Public vs. Private

Because limited partnership interests are considered securities, their issuance, sale, and transfer are subject to federal and state security laws. The federal securities laws are administered by the Securities and Exchange Commission (SEC) and are designed to protect the investor by requiring the
sponsor of such securities to make a full and fair disclosure of all pertinent facts material to making an informed investment decision. The laws do not provide for the SEC to advise upon the merits of any investment whatsoever.

The SEC and the Securities Exchange Act of 1934 provide for exemption from registration where the benefit to the public provided by registration is too remote. The rules for exemption from registration are found within Section 4(2) which guides offerings within those parties clearly able to fend for themselves (i.e., offerings made to substantial investors like major corporations), and within Regulation D (promulgated by the SEC in 1982) which governs offerings limited in distribution. (Intrastate offerings are also exempt.) In all cases, full disclosure of material information relevant to making an investment decision is required whether or not exempt from registration. Quite simply then, those offerings which require registration with the SEC are considered "public offerings," all others are considered "private offerings."

Compliance with the requirements of Regulation D determines those RELPs which need not register with the SEC. The central concept in compliance with this regulation revolves around the restriction in sales of such securities to non-accredited investors. In general, such securities may not
be sold to more than 35 investors who fail to meet the standards of an accredited investor as defined within Reg D. (Note: Offerings in which less than $500,000 is raised from investors are exempt regardless of the level of sophistication or number of investors provided no general solicitation takes place.) In the event that any interests are sold to non-accredited investors, a full disclosure of information as required in a public offering must be made. In all cases, a notice of sale must be made with the SEC.

The definition of an accredited investor depends upon highly technical definitions and changes often, but generally means those investors of significant net worth (over $1 million exclusive of home and automobiles) or income (in excess of $200,000 for the previous two years and expectations of the same amount for the current year). Determination of whether any investor meets the requirements of accreditation rests with the sponsor of the security.

As a result of the exemption requirements, two markets for RELPs have developed -- public and private. Because public RELPs must go through the registration process, information describing these offerings has been tracked by a number of organizations, predominantly the Shrewsbury, New Jersey-based Robert A. Stanger Company. Private offerings skirt the
registration process and information concerning the types of offerings does not come under public scrutiny. Although the amount raised by private offerings has been known in the past through Form D filings, exact figures are not available currently because the sponsor needs now only specify the amount intended to be raised, not the amount actually raised.

**Blind Pool versus Specified Property**

When organizing the RELP, the sponsor need not determine specific properties that will comprise the assets of the partnership upon capitalization. (The general partner must identify the purpose for which the funds raised will be employed, however.) In these cases, sponsors term the offering as a "blind-pool". The investor relies upon the wisdom and experience of the general partner is selecting the portfolio after the funds have been raised. This term can also apply to those partnerships where some assets have been identified for investment but do not equal the total funds raised. This contrasts with the "specified" offering in which the deployment of partnership funds has been identified prior to the offering.

Public offerings tend to be "blind-pools" (approximately 75%) while private offerings are almost always "specified". Because public offerings allow for solicitation to a broader
market base, the amount raised by such offerings tends to be larger than those of private offerings. (In part, the costs of a public offering run in the hundreds of thousand dollar range thereby necessitating a larger amount of funds be raised in order to amortize such costs. Also, since the investors in such public offerings need not be accredited, the smallest unit size or partnership interest tends to be in smaller denominations usually in the $1,000 to $5,000 range.) For example, in January, 1985, the average public offering available equaled $47 million. With such a large pool of potential funds combined with the uncertainty of whether or not the entire offering will be sold, most public syndicators cannot identify asset acquisitions until well into or after the offering period. On the other hand, almost all private offerings are specified prior to the offering. Sponsors of private offerings generally seek fewer investors and raise smaller dollar amounts thus making it almost a necessity to have identified the target acquisition prior to the offering. This results from the limited distribution of the private offering and its sizable partnership unit sizes (usually between $10,000 and $50,000).
Tax Shelter versus Economic

The ERTA of 1981 incorporated tax incentives that allowed real estate deals to be structured for substantial tax-losses without incurring cash drains upon the investors. This led to the explosive growth of the private syndication market as sponsors rushed to produce product for the high net worth individuals who could benefit most from the tax losses. These deals tended to be highly leveraged with tax write-offs often exceeding two dollars for every dollar invested. The TRA of 1986 eliminated many of the tax breaks and caused a large disruption in the overall sales levels of private deals beginning even prior to enactment of the law. The public market, while affected, suffered less as most public deals were not motivated by tax-shelter investment. (This resulted partly from the economic base of the investor pool and also because public offerings could not permit staged pay-in periods for investors. Staged pay-ins provided partners in private deals the ability to offset the investment amount each year with annual tax savings created by excess losses. Beginning in 1986, public partnerships could offer staged pay-ins on a limited basis, however.)

Most recently, public deals have trended towards low
leveraged or all-cash investment and acquisition in an attempt to increase current income. (See EXHIBIT 5.) For example, in 1982, 76% of the equity RELPs (by dollars raised) used debt for more than 50% of the total consideration in the acquisition of assets. By 1987, the percentage of total RELP equity deals using high leverage dropped to less than 20%. The use of leverage decreases the amount of cash flow immediately available to the investor because of debt service. (Most real estate deals organized during the 1980s, if leveraged, were negatively leveraged meaning that the cost of financing exceeded the capitalization rate of the investment. Thus, the use of leverage in these cases automatically decreases the investors' return on investment at the start of an investment program.) Those deals where the primary component of return is cash distributions are considered economic deals.

Whether public or private, tax or economic deals, RELP interests, as a security, are not very liquid. According to George Hamilton, President of the National Partnership Exchange, "the pressure for liquidity in RELP markets is low, less than 1% of limited partners liquidate in any given year."

No markets exist for the exchange of these securities,
EXHIBIT 5

PUBLICLY REGISTERED EQUITY RELP SALES BY AMOUNT OF LEVERAGE 1982-1987
($ 000,000s)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>HIGHLY - LEVERAGED</td>
<td>1,492.0</td>
<td>2,549.8</td>
<td>2,380.9</td>
<td>2,321.7</td>
<td>2,414.8</td>
<td>918.4</td>
</tr>
<tr>
<td>LOW - LEVERAGED</td>
<td>456.2</td>
<td>920.9</td>
<td>1,953.3</td>
<td>2,890.1</td>
<td>3,486.1</td>
<td>3,874.2</td>
</tr>
<tr>
<td>TOTAL EQUITY PARTNERSHIPS</td>
<td>1,948.2</td>
<td>3,470.7</td>
<td>4,334.2</td>
<td>5,211.8</td>
<td>5,902.9</td>
<td>4,792.6</td>
</tr>
</tbody>
</table>

Percentage Distribution

<table>
<thead>
<tr>
<th></th>
<th>HIGHLY - LEVERAGED</th>
<th>LOW - LEVERAGED</th>
<th>TOTAL EQUITY PARTNERSHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>76.6%</td>
<td>23.4%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>73.5%</td>
<td>26.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>54.9%</td>
<td>45.1%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>44.5%</td>
<td>55.5%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>40.9%</td>
<td>59.1%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>19.2%</td>
<td>80.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>54.9%</td>
<td>55.1%</td>
<td>100.0%</td>
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<tr>
<td></td>
<td>59.1%</td>
<td>80.8%</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>19.2%</td>
<td>80.8%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Notes:

Highly - Leveraged: Leverage in excess of 50% of total asset purchase.

Low - Leveraged: Leverage equal to or less than 50% of total asset purchase.

Source: Robert A. Stanger & Co.
although there are several organizations which buy and sell interests in addition to firms which make a listing of buyers and sellers. It is not expected that any markets for partnership units will develop due to the problems in evaluating the existing status of any partnership and the cost in disseminating such information. (There are some partnerships which have been "rolled-up" into a Master Limited Partnership which do trade on securities exchanges. Usually this involves the combination of one sponsor's existing partnerships into one MLP. Whether or not more sponsors engage in this activity remains to be determined.)

B. Real Estate Products and Investor Preferences

EXHIBIT 6 details the composition of public RELPs by real estate product since 1981. Information for making this table comes from the description of the stated objectives of the syndication offerings. Commercial/Residential, consistently the largest category with more than 25% of the offerings in each year, suggests that most public syndications do not discriminate whether or not the ultimate asset portfolio will include commercial or residential properties. This category
EXHIBIT 6
COMPOSITION BY PROPERTY TYPE FOR PUBLICLY REGISTERED OFFERINGS
1981 - 1987
($ 000,000s)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial/Residential</td>
<td>603.6</td>
<td>556.5</td>
<td>1,533.1</td>
<td>2,263.8</td>
<td>2,925.7</td>
<td>2,224.9</td>
<td>1,286.5</td>
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<tr>
<td>Commercial</td>
<td>356.2</td>
<td>270.9</td>
<td>788.6</td>
<td>857.9</td>
<td>1,362.2</td>
<td>1,833.2</td>
<td>1,493.9</td>
</tr>
<tr>
<td>Residential</td>
<td>342.9</td>
<td>390.0</td>
<td>583.0</td>
<td>431.6</td>
<td>311.6</td>
<td>318.1</td>
<td>973.1</td>
</tr>
<tr>
<td>Subsidized Housing</td>
<td>66.0</td>
<td>107.3</td>
<td>168.0</td>
<td>196.1</td>
<td>98.6</td>
<td>33.2</td>
<td>23.0</td>
</tr>
<tr>
<td>Mini-Warehouse</td>
<td>73.0</td>
<td>100.3</td>
<td>164.1</td>
<td>278.0</td>
<td>481.0</td>
<td>396.8</td>
<td>196.8</td>
</tr>
<tr>
<td>Commercial Net Lease</td>
<td>32.3</td>
<td>173.1</td>
<td>192.6</td>
<td>244.6</td>
<td>303.5</td>
<td>727.6</td>
<td>378.6</td>
</tr>
<tr>
<td>Hotels/Motels</td>
<td>58.5</td>
<td>47.1</td>
<td>51.1</td>
<td>54.6</td>
<td>108.5</td>
<td>331.6</td>
<td>358.2</td>
</tr>
<tr>
<td>Mobile Homes</td>
<td>***</td>
<td>3.6</td>
<td>0.2</td>
<td>7.6</td>
<td>28.7</td>
<td>37.5</td>
<td>82.5</td>
</tr>
<tr>
<td>Total Sales</td>
<td>1,512.5</td>
<td>1,948.2</td>
<td>3,470.7</td>
<td>4,334.2</td>
<td>5,211.8</td>
<td>5,902.9</td>
<td>4,792.6</td>
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PERCENTAGE DISTRIBUTION

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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial/Residential</td>
<td>39.9%</td>
<td>44.0%</td>
<td>44.2%</td>
<td>52.2%</td>
<td>46.5%</td>
<td>37.7%</td>
<td>28.8%</td>
</tr>
<tr>
<td>Commercial</td>
<td>23.6%</td>
<td>13.2%</td>
<td>22.7%</td>
<td>19.8%</td>
<td>26.1%</td>
<td>31.1%</td>
<td>31.2%</td>
</tr>
<tr>
<td>Residential</td>
<td>22.2%</td>
<td>20.0%</td>
<td>14.8%</td>
<td>10.0%</td>
<td>6.0%</td>
<td>5.4%</td>
<td>20.3%</td>
</tr>
<tr>
<td>Subsidized Housing</td>
<td>4.4%</td>
<td>5.5%</td>
<td>4.8%</td>
<td>4.5%</td>
<td>1.9%</td>
<td>0.6%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Mini-Warehouse</td>
<td>4.8%</td>
<td>5.1%</td>
<td>4.7%</td>
<td>6.4%</td>
<td>9.2%</td>
<td>6.7%</td>
<td>4.1%</td>
</tr>
<tr>
<td>Commercial Net Lease</td>
<td>2.1%</td>
<td>8.9%</td>
<td>5.3%</td>
<td>5.6%</td>
<td>5.8%</td>
<td>12.3%</td>
<td>7.9%</td>
</tr>
<tr>
<td>Hotels/Motels</td>
<td>2.5%</td>
<td>2.4%</td>
<td>1.5%</td>
<td>1.3%</td>
<td>1.9%</td>
<td>5.6%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Mobile Homes</td>
<td>***</td>
<td>0.2%</td>
<td>0.0%</td>
<td>0.2%</td>
<td>0.6%</td>
<td>0.6%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Note:

*** - included in Residential category

Source: Robert A. Stanger & Co.
includes all kinds of commercial properties -- office buildings, industrial buildings, and retail centers -- as well as any kind of residential property, generally apartments and mobile homes. In one sense, this latitude allows the sponsor to invest in a broad range of property types. In the past several years, the percentage composition of the total market shows a decline in interest for RELPs seeking to invest in both commercial and residential properties within the same partnership. Rather, the percentages indicate a trend towards greater definition in the type of property acquired. Between 1986 and 1987, Commercial/Residential category slipped considerably by 40% while Residential-only programs gained over 200% in sales. Barbara Pivnica, a consultant with Roulac Consulting, believes that the trend towards more specification within public programs as to both property type and identified properties will become more common. Syndicators will find it easier to sell a program that details more specifics of the investment orientation.

Programs which invest in specific property types make up the remaining categories. The commercial net lease programs experienced considerable attention in 1986 as syndicators rushed to develop passive income programs. These commercial net lease programs acquire only properties leased on a triple-net basis to tenants, generally property with single
tenants such as fast-food outlets with little or no leverage. As a result, these programs throw-off cash distributions immediately and little or no tax benefits. Subsidized housing RELPs suffered a considerable drop in total sales from a high of $194 million in 1984 to only $23 million in 1987. Yet, public syndicators claim that investors now clamor for this product today given certain tax shelter benefits remaining with this investment.

Investors do not exhibit a consistent appetite for a "typical" product offering. The sudden shifts in product offerings between categories may indicate that investors for public product do not discriminate greatly between product types; instead, the product bought might be in response to a "herd" mentality among investors to respond to the current "hot" product pushed by sales agents. In one sense, investors may only be looking for a specific kind of return offered -- growth, current income, or tax shelter -- and do not really pay any attention to the underlying asset.

Determining the investor base for public limited partnerships defies analysis. The single most difficult problem stems from the fact that each and every sponsor maintains that such information describing the investor base is proprietary in nature and should not be disclosed. Sales of
RELPs remain an important asset type for investors. According to a report in The Stanger Register in January, 1986, which summarized a 1985 survey of broker/dealers, RELPs made up more than 40% of the average client's portfolio in 20% of the firms surveyed. For more than half of the firms surveyed, RELPs made up more than 25% of the average client's portfolio. Of those seeking investment in RELPs, more than 50% of the investor base seeks income- or growth-oriented partnerships when considering partnership investments. The balance desired tax-sheltering partnerships, although the trend among investors in 1985 seemed to be moving away from tax-shelter products. Sixty-nine percent of the firms surveyed indicated that clients wanted income products and 25% of the firms signaled a trend toward growth products.

The composition of returns to the investor becomes the item of significance when thinking about the real estate product. Can investor preferences be met by constructing a variety of partnership offerings? For example, those investors desiring current income, the acquisition of existing properties for all-cash (unleveraged) might be most suitable. For those investors willing to take more risk, the growth type partnership such as those involving some degree of value-added enhancements (e.g., development offerings) might be more suitable. Based on the historical record presented in EXHIBIT
7, investors appear to prefer to invest in RELPs which intend to acquire existing properties. These syndications accounted for more than 80% of all offerings since 1983. Whether this will continue in light of the historical performance of such offerings remains to be determined.

C. Sponsor Types

RELPs simply would not exist without the motivation of entrepreneurial firms to risk the capital needed to organize the partnership, especially public deals. The primary motivation for such sponsors has been the potential for sizable fees which come from the front-end load of the partnership. According the Robert Stanger Co., these fees traditionally have been anywhere from 18% to 30% of the total capital raised. A portion of these fees repay sponsors for the costs of assembling and organizing the partnership, yet a good part, probably over 50%, represent profit to the sponsor. As the industry has matured, the amount of compensation to the sponsor has decreased since 1985, as shown in EXHIBIT 8, with a typical front-end load today of less than 20%. (Note: EXHIBIT 8 shows the relative sponsor compensation according to Stanger Co.'s ranking system.)
## EXHIBIT 7
PUBLIC EQUITY PARTNERSHIPS BY REAL ESTATE ACTIVITY
1983-1988

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
<th></th>
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<tr>
<td>Total Program Offerings</td>
<td>96</td>
<td>130</td>
<td>144</td>
<td>188</td>
<td>180</td>
<td>143</td>
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<tr>
<td>Intent to Invest in:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Existing</td>
<td>74</td>
<td>98</td>
<td>106</td>
<td>144</td>
<td>140</td>
<td>102</td>
</tr>
<tr>
<td>Existing / To Be Built</td>
<td>15</td>
<td>12</td>
<td>19</td>
<td>22</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Under Construction / To Be Built</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>To Be Built</td>
<td>6</td>
<td>17</td>
<td>14</td>
<td>17</td>
<td>20</td>
<td>19</td>
</tr>
<tr>
<td>PERCENTAGE DISTRIBUTION</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Program Offerings</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
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<tr>
<td>Intent to Invest in:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Existing</td>
<td>77%</td>
<td>75%</td>
<td>74%</td>
<td>77%</td>
<td>78%</td>
<td>71%</td>
</tr>
<tr>
<td>Existing / To Be Built</td>
<td>16%</td>
<td>9%</td>
<td>13%</td>
<td>12%</td>
<td>8%</td>
<td>11%</td>
</tr>
<tr>
<td>Under Construction / To Be Built</td>
<td>1%</td>
<td>2%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>To Be Built</td>
<td>6%</td>
<td>13%</td>
<td>10%</td>
<td>9%</td>
<td>11%</td>
<td>13%</td>
</tr>
</tbody>
</table>

**Note:**
Data based on Stanger Partnership Listings of currently offered equity partnerships as of May for each year. Includes specified programs.

Source: Robert A. Stanger & Co.
EXHIBIT B

COMPARISON OF
RELATIVE SPONSOR COMPENSATION LOAD
1985 versus 1988

<table>
<thead>
<tr>
<th></th>
<th>Ratings</th>
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<th>Ratings</th>
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<td></td>
<td>AAA+ - AA+</td>
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<td>AA - BBB</td>
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<td>Number</td>
<td>Percentage</td>
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<td>Percentage</td>
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<td>-------</td>
<td>---------------------------------</td>
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<tr>
<td>1988</td>
<td>77</td>
<td>1985</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>53.5%</td>
<td></td>
<td>23.7%</td>
</tr>
<tr>
<td>1987</td>
<td>64</td>
<td>1986</td>
<td>121</td>
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<tr>
<td></td>
<td>44.1%</td>
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<td>28.8%</td>
</tr>
<tr>
<td>1986</td>
<td>49</td>
<td>1985</td>
<td>106</td>
</tr>
<tr>
<td></td>
<td>28.8%</td>
<td></td>
<td>23.7%</td>
</tr>
</tbody>
</table>

Explanation:
The Robert A. Stanger Company rates RELP offerings according to risk and offering terms. This rating measures the investor's share of partnership returns assuming uniform economic performance. AAA+ rated partnerships are most favorable to the investor, BBB rated partnerships are least favorable. Only equity partnerships offered in March of each year are included in this table. This merely serves as a representative sample. Ratings for other times of the year might show slight variations but would only be indicative of a different stage of the same trend.

Source: Robert A. Stanger & Company
The interesting question of fee load relates to its impact upon investor returns. Clearly, if a sponsor takes out 25% of all investment dollars for an all-equity acquisition, then the sponsor must ensure that the properties acquired must increase in value by at least that amount in order for the investor to break-even on a return-of-capital basis. For leveraged acquisitions, the amount of increase need not be as significant. How this will impact the overall return to the investor cannot be determined without an evaluation comparing investment returns with and without the fee compensation to the sponsor. It suffices to state that, ceteris paribus, investor returns should increase as the overall compensation to the sponsor decreases.

Selling the real estate partnership interest becomes the primary objective of the sponsor once the RELP has been organized. Because the interest is considered a security, only NASD broker/dealers are permitted to sell these interests. As a result, the regional and national brokerage firms sell the bulk of such securities today. Yet, in the early part of the 1980s, sponsors often organized their own securities firms to distribute such securities directly to investors. As a result, the Wall Street brokerage firms have increased their presence
in the creation and sales of RELPs given their existing network of brokerage outlets. This trend, shown in EXHIBIT 9, illustrates the relative change in rankings of the top ten sellers of RELPs between 1981 and 1988. These firms have realized that their ability to distribute product places them in the best position to assemble and sell their own product instead of selling the product of others. According to John Gagliano of PaineWebber Properties, "it was only a matter of time until the Wall Street houses woke up and realized that they could assemble and sell partnerships as well as anyone. That's why we have become more aggressive in this market."

The sponsor, being the general partner of the RELP, controls the management of the partnership and must make all investment decisions. Organizing and registering the partnership, selling the partnership units, and acquiring suitable investment properties constitute the three roles which the sponsor must successfully complete to realize the ultimate aim of the RELP. To organize the partnership, the sponsor must assemble an offering memorandum which describes all material facts and risks pertinent to achieving the purpose of the RELP. This document can be hundreds of pages and often involves the work of several professional consultants, especially legal and accounting services. Upon completion of this document, the
EXHIBIT 9

HISTORICAL RANKING OF RELP SPONSORS BY SALES VOLUME
1981 - 1987

($ 000,000s)

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
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</thead>
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<td>JMB Realty Corp.</td>
<td>1</td>
<td>$196.2</td>
<td>2</td>
<td>$551.0</td>
<td>1</td>
<td>$585.0</td>
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<td>Prudential-Bache</td>
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<td>2</td>
<td>$489.8</td>
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<tr>
<td>Krupp Corporation</td>
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<td>3</td>
<td></td>
<td>3</td>
<td>$475.0</td>
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<tr>
<td>Shearson Lehman</td>
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<td>4</td>
<td></td>
<td>4</td>
<td>$322.0</td>
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<td>C.R.I. Inc.</td>
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<td>5</td>
<td></td>
<td>5</td>
<td>$307.3</td>
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<tr>
<td>Integrated Resources</td>
<td>7</td>
<td>$62.3</td>
<td>9</td>
<td>$150.7</td>
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<td>$335.0</td>
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<tr>
<td>E.F. Hutton</td>
<td>X</td>
<td>$64.7</td>
<td></td>
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<tr>
<td>Dean Witter</td>
<td>*</td>
<td></td>
<td>8</td>
<td></td>
<td>B</td>
<td>$251.4</td>
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<tr>
<td>Baicor</td>
<td>2</td>
<td>$135.9</td>
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<td>$581.5</td>
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<td>$834.8</td>
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<td>$193.1</td>
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<tr>
<td>PaineWebber</td>
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<td></td>
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<tr>
<td>Merrill Lynch</td>
<td>X</td>
<td>$261.2</td>
<td>3</td>
<td></td>
<td>3</td>
<td>$500.0</td>
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<td>American 1st Capital Assoc.</td>
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<td>4</td>
<td>$379.4</td>
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<tr>
<td>Oxford Development</td>
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<td>6</td>
<td></td>
<td>6</td>
<td>$324.2</td>
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<td>Franchise Finance Corp.</td>
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<td>7</td>
<td></td>
<td>7</td>
<td>$301.8</td>
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<td>Consolidated Capital</td>
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<td>$282.8</td>
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<td>Public Storage</td>
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<td>9</td>
<td>$281.3</td>
<td>*</td>
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<tr>
<td>Fox &amp; Caruskodan</td>
<td>3</td>
<td>$129.0</td>
<td>5</td>
<td>$201.4</td>
<td>10</td>
<td>$239.6</td>
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<tr>
<td>Equitec Financial Group</td>
<td>9</td>
<td>$46.4</td>
<td>6</td>
<td>$175.4</td>
<td>*</td>
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<td>Winthrop Corp.</td>
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<tr>
<td>Shelter Realty Corp.</td>
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<td>$49.5</td>
<td>*</td>
<td></td>
<td>*</td>
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<td>National Partnership Corp.</td>
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<td>$41.0</td>
<td>*</td>
<td></td>
<td>*</td>
<td></td>
<td>*</td>
<td></td>
</tr>
</tbody>
</table>

Notes:

* - Not ranked within top ten sponsors.
X - Wall Street Brokerage

Source: Robert A. Stanger & Company
partnership must be registered with the SEC and in any states in which it will be sold. (In the case of the individual states, the offering memorandum must meet any applicable state "blue-sky" requirements prior to sale.) These requirements often involve considerable time and expense, mostly legal assistance, to insure that the offering meets all such imposed requirements for disclosure as well as filed with all appropriate governing agencies.

Several considerations are involved when contemplating the organization of the RELP. First, the sponsor must have some belief that the security created can and will be sold to investors. A track record of successfully organizing and selling RELPs helps. Second, the sponsor, if a corporation, must meet certain minimum net worth requirements imposed by the IRS to insure that the organization formed will be taxed as a partnership. (Revenue Procedure 72-13 spells out these requirements. Essentially, a corporation have a net worth equivalent to 10% or more of the total contributions to the partnership if such contributions exceed $2,500,000. (Revenue Procedure 72-13, 1972-1 C.B. 735) Failure to reach this minimum may involve the reclassification of the partnership as a corporation thereby denying the benefits of partnership for tax purposes. Third, the sponsor must be able to fund the cost of organizing the partnership. These costs can run several
hundred thousand dollars or more for a public offering depending upon the anticipated geography of distribution.

To sell the securities, a sponsor can organize his own distribution network or sell interests through other sources, most notably national and/or regional brokerage firms. Insurance companies, through their network of agents, also sell RELPs though to a lesser extent than the brokerage firms. The standard fee for selling partnership interests is 8% of the funds raised. Brokerage firms and other firms which sell RELPs often perform extensive due diligence on a sponsor prior to qualifying the sponsor's offerings for sale. Of course, no guarantees exist that a sales organization will take on a new sponsor. Given that the brokerage firms have become more involved in creating proprietary product, the more difficult it may become for new sponsors to sell through this channel.

Besides organizing the RELP, the sponsor manages the partnership and, in some cases, directly manages the properties acquired as well. Typically, the largest non-Wall Street firms provide their own property management through subsidiary management companies. The Wall Street sponsors utilize outside property management services to perform the daily management responsibilities. An interesting question raised by this distinction centers on whether the investor does better when
the sponsor provides direct property management versus contracting with third-party vendors?
A. Examining the Returns

Investors have bought RELP's for a number of years, and, after a solid record of growth since 1981, market sales have declined. While the TRA of 1986 dampened investor appetite due to the change in the tax treatment of income and losses, a potentially bigger reason for the decline may be due to negative investor perceptions of the actual return received by investing in these deals. One author writes that "these investor perceptions are the result of the non-performance of many real estate syndications and a great deal of negative publicity about syndicated real estate and overbuilt markets."

According to John Rosek of New England Securities, many RELPs failed to perform as anticipated, mostly due to the high prices paid for the property and the severe economic dislocations in several parts of the country, especially in Texas. In addition, he feels that investors forgot that a
percentage of the anticipated return included some tax-shelter benefits, something that went away with the 1986 Tax Reform Act. The combination of these two factors lead to a general disillusionment with these investments.

PaineWebber Properties prepared a booklet outlining the returns to the limited partners for all of the RELPs sold through their agents from 1979. While not comprehensive, the booklet does provide data on cumulative distributions from operations and sales or refinancing since the inception of each partnership through the end of 1986. This information comes directly from the sponsors themselves, and in some cases, includes performance on RELPs not sold by PaineWebber. Quite frankly, the returns to the investors appear slim at best for those partnerships organized after 1980. For example, out of the 15 public equity partnerships organized by Balcor from 1981 forward, only five had made any cash distributions to the investors by the end of 1986. (Balcor may have organized other partnerships during this period but only those included in this report by PaineWebber are represented. The RELPs included here were for the leveraged acquisition of income-producing properties, both residential and commercial.) For those RELPs that made distributions, only one returned 5% on an annual basis including distributions from sales or refinancing of properties! Excluding distributions made from sales or
refinancing, the average annual return for those partnerships making distributions equalled less than 2%.

While the objective of these partnerships was to provide short-term tax benefits and long-term appreciation, the value of the cash distributions is minimal as a component of return. This shows that these deals are uneconomic and serve as evidence why investors have become disillusioned. It should be stated that the RELPs organized in the 1970's appear to have performed somewhat better. This most likely resulted from the lower tax-shelter incentives of this period and because of the maturing of the properties during the inflationary period of the late 1970s. The best performing partnership, Balcor Income Properties, organized in 1977, has returned 7% on invested funds annually and has completely returned the original investment to the limited partners. This partnership has only one of its original fourteen properties remaining in its portfolio which, according to the limited information, appears to be having problems in leasing and occupancy and will not enhance the overall return.

The Carlyle RELPs organized by JMB, one of the largest sponsors during the 1980s perform no better than those of Balcor. This series of RELPs are more risk-oriented because they involve investments in properties under development or
newly constructed. Even so, not one partnership out of six organized after 1980 has returned more than 1% on invested funds through December, 1986. Of the 10 organized prior to 1981, two had sold all of their investments by the end of 1986. These two partnerships, organized in 1971 and 1972, returned $766 and $623 from operations and $2,604 and $3,212 of sales proceeds respectively for each $1,000 of investment. As presented, this translates to an average annual return of 15.8% and 20.2% from operations and sales proceeds respectively. Yet, this return proves deceiving because it is calculated by taking the overall return and dividing it by the number of years of partnership operation. On a compounded basis, the returns are quite different. Assuming that the proceeds from operations were distributed at the middle of the partnership lives and sales proceeds at the end, the compound return or IRR for the 1971 fund equals 9.8% and, for the 1972 fund, 11.4%. Because the actual timing of the returns is not known, the real return may be better or worse than the above figures. Assuming the returns from operations and distributions occurred uniformly over time, then the IRR for the 1971 and 1972 fund would equal 21.2% and 26.4% respectively. If all the distributions came at the end in 1986, however, the IRR would drop dramatically to 8.4% and 10.1% for the 1971 and 1972 funds, respectively.
While the relative diminutive returns for RELPs organized by the two largest sponsors may not be indicative of the entire market, this information does help to show that RELPs do not make one tremendously wealthy. In fact, since 1981, these securities have provided miniscule returns exclusive of tax benefits. This paper, however, focuses on a look at the potential returns from RELPs created for securitizing different stages of the development cycle. To do this, actual returns from two types of partnerships -- land development and acquisition of existing properties have been compared. Centennial Group, a land development firm located in Southern California, actively pursues land development by organizing capital through public syndication. Information regarding the first three deals sponsored by this group are included in EXHIBIT 11. The returns to limited partners from partnership securitizing the acquisition of existing properties by the Angeles Group have been shown in EXHIBIT 10. The following section of this chapter analyzes the returns of these RELPs.

B. Review of Selected Partnership Returns

Angeles Corporation was one of the first companies to create, market, and manage RELPs. Formed in 1969, this firm has brought to market more than 60 RELPs and, by the end of 1986, had raised more than $620 million in capital from more
than 50,000 investors. Currently, this syndicator has more than 20 public programs outstanding, both leveraged and unleveraged. EXHIBIT 10 shows the returns to investors of three programs from this syndicator. The returns from the programs include only cash distributions from both operations and sale or refinancing with an appraised value of the partnership to the investors for a final residual component of return. Leverage used in these partnerships is minimal and all were organized as blind-pools. According to the offering prospectuses, the primary objective of these partnerships are to 1) maximize cash distributions; 2) preserve and protect investor capital; 3) obtain capital appreciation; and 4) make acquisitions by paying a significant portion of the purchase price in cash. Tax benefits are not mentioned as a goal of these partnerships. Property acquisition occurred within 18 months of organization for all programs.

The first program (Angeles Income Properties, Ltd.), organized in 1981, acquired seven properties -- five residential and two commercial -- located primarily in California and Florida and two have been sold, one each in 1986 and 1987. The second program (Angeles Income Properties, Ltd. II), organized in 1983, acquired five properties -- three residential and two commercial -- located in Alabama, Indiana, and North Carolina. None of the properties have been sold
although one property was refinanced in 1986. The third program (Angeles Income Properties, Ltd. III), organized in 1984, acquired six properties -- two residential and four commercial properties -- all located in different states. The performance results of these RELPs are shown in EXHIBIT 10.

The Angeles Partnerships do not perform consistently in terms of returns. It appears that the newer the partnership, the lower the IRR as shown in the exhibit. Income Properties (AIP), the first partnership, was organized in the summer of 1981 and distributed its first return to investors in 1982 of 7.4%. In subsequent years, the yield increased to 8% with additional distributions from sales in 1986 and 1987. The overall IRR for this investment equals 7.9% based on cash returns. This is less than the assumed "risk-free" rate of 8%.

Income Properties III (AIP III), formed in 1984, returned 7.5% in 1985 but decreased in subsequent years. This partnership shows a negative IRR; investors have actually experienced a decrease in value. Angeles Income Properties II (AIP II), organized in 1983, falls between these two in terms of performance. It should be noted that the IRR calculation is based on the dissolution of the partnerships today using an appraised value for calculating the net residual to the
### EXHIBIT 10

**PERFORMANCE RESULTS OF SELECTED ANGELES CORPORATION PARTNERSHIPS**

<table>
<thead>
<tr>
<th>Income Properties (AIP)</th>
<th>Income Properties Fund II (AIP II)</th>
<th>Income Properties Fund III (AIP III)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date Organized</td>
<td>July-81</td>
<td>March-83</td>
</tr>
<tr>
<td>Amount Raised</td>
<td>$40,000,000</td>
<td>$50,000,000</td>
</tr>
<tr>
<td>Number of Properties</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Leverage at Inception</td>
<td>2%</td>
<td>20%</td>
</tr>
</tbody>
</table>

#### Cash Distributions by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Income Properties Fund I (AIP I)</th>
<th>Income Properties Fund II (AIP II)</th>
<th>Income Properties Fund III (AIP III)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1982</td>
<td>$2,960,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1983</td>
<td>$3,220,000</td>
<td>$3,500,000</td>
<td>$782,280</td>
</tr>
<tr>
<td>1984</td>
<td>$3,220,000</td>
<td>$3,500,000</td>
<td></td>
</tr>
<tr>
<td>1985</td>
<td>$3,220,000</td>
<td>$3,500,000</td>
<td>$3,259,500</td>
</tr>
<tr>
<td>1986</td>
<td>$30,000,000</td>
<td>$11,150,000</td>
<td>$2,607,600</td>
</tr>
<tr>
<td>1987</td>
<td>$2,600,000</td>
<td>$1,500,000</td>
<td></td>
</tr>
</tbody>
</table>

**Total Distributions**

- $49,160,000
- $21,400,000
- $9,039,680

**Net LP Value as of Oct-87**

- $7,800,000
- $34,500,000
- $32,631,000

**IRR to date**

- 7.9%
- 3.4%
- -1.3%

**Profitability Index**

- -0.08
- -0.20
- -0.28

---

**Notes:**

1) Refinancing of $31 MM of which $30 MM distributed to limited partners.
2) Property Sales of $14.5 MM and $8.6 MM for net gain of $8.4 MM of which $6.6 MM distributed to limited partners.
3) Refinancing of $9.7 MM

**Source:** Angeles Corporation
investors. Because the objective of the partnerships is to hold such properties until it becomes advantageous to refinance or dispose of the properties, the actual IRR to the investor may be more or less than the value calculated today. The profitability index for all three partnerships is negative. This underscores the returns being less than our "risk-free" rate of 8%.

While the results should not be uniform, the disparity in the IRRs may be due to the "maturity" of the partnerships. Yet, these RELPs only invest in existing properties which should already be producing cash flow from the start. It is interesting that AIP III shows a decrease in yield over time from the start of the partnership! There are two possible explanations for the trend in performance between the three partnerships. First, the two newer partnerships had more leverage at the inception of the partnerships than the first, and AIP III is leveraged the most at 29%. In addition, for AIP III, financing terms include notes payable ranging in cost between 8.3% and 16.5% suggesting that negative leverage exists for this partnership. This leverage may make the cash flows more sensitive to changes in operating income from the properties. Second, the more recent the partnership, the greater the investment in commercial properties. Whereas AIP invested 42% of the total dollars in commercial properties, AIP
III invested 82%. AIP II falls in between at 45%. It may be that commercial properties experience greater variations in cash flow than residential properties in the short term. This would make comparisons between AIP and AIP III not meaningful given the short history of the third partnership.

Overall, the performance of these RELPs suggests that the yield for such RELPs investing in existing property may not be substantial. The ability of the partnerships to acquire properties at favorable terms does not hold true. While the individual investor may not be able to buy such properties on his own, he could do better by investments in other higher yielding securities. The evidence presented is based on data from RELPs existing for only a limited period. If one could peer into the future, the returns from these RELPs could be much different and might alter these conclusions. Even so, existing properties, with the absence of inflation, do not offer enough reward for the investment.

The Centennial Group, Inc. was formed in 1987 to consolidate the six public partnerships formed since 1979 by the general partner, the same entity which formed all six partnerships. These six partnerships raised more than $197 million in funds and controlled almost 4,000 acres of land in various stages of development and 300,000 square feet of
commercial space already in operation or under construction. All of the partnerships acquired land with the objective of increasing value through development. All purchases were located primarily in three areas: Riverside/San Bernadino, California; Sacramento, California; and Phoenix, Arizona. Each partnerships was organized as a blind-pool with property acquisition completed within two to three years after partnership formation. The use of leverage varied greatly between partnerships, but none exceeded 70% of total asset value. There are minimal tax benefits associated with land development syndications with such benefits varying depending on the amount of leverage. With the roll-up of the six partnerships into a stock corporation, net asset values of each of the partnerships were determined as of December, 1986. Returns to the limited partners of the first three RELPs, calculated as if the partnerships were dissolved in December, 1986 and the appraised values realized, are shown in EXHIBIT 11

The results from investment in the Centennial partnerships are, at best, disappointing. Given the expectations of risk and reward, investors must be disenchanted. (It could be that the poor performance enticed the general partners to roll-up the partnerships into a stock corporation so that all investors
## EXHIBIT 11

**Performance Results of Selected Centennial Partnerships**

<table>
<thead>
<tr>
<th>Capital Fund</th>
<th>Development Fund II</th>
<th>Development Fund III</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date Organized</strong></td>
<td>September-79</td>
<td>August-81</td>
</tr>
<tr>
<td><strong>Amount Raised</strong></td>
<td>$18,655,000</td>
<td>$14,499,000</td>
</tr>
<tr>
<td><strong>Appraised Value (12/86)</strong></td>
<td>$37,599,800</td>
<td>$27,540,100</td>
</tr>
<tr>
<td><strong>Debt</strong></td>
<td>$24,278,600</td>
<td>$10,593,300</td>
</tr>
<tr>
<td><strong>Percent Leveraged</strong></td>
<td>65%</td>
<td>38%</td>
</tr>
</tbody>
</table>

### Cash Distributions by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Fund</th>
<th>Development Fund II</th>
<th>Development Fund III</th>
</tr>
</thead>
<tbody>
<tr>
<td>1979</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1980</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1981</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1982</td>
<td>$4,600,000</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1983</td>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>1984</td>
<td>$3,768,000</td>
<td>$850,000</td>
<td>---</td>
</tr>
<tr>
<td>1985</td>
<td>$3,033,700</td>
<td>---</td>
<td>$449,500</td>
</tr>
<tr>
<td>1986</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total Distributions</strong></td>
<td>$11,401,700</td>
<td>$850,000</td>
<td>$449,500</td>
</tr>
</tbody>
</table>

| Residual Value | $13,321,200 | $17,146,800 | $54,015,500 |
| IRR | 5.0% | 4.5% | 7.3% |
| Profitability Index | -0.21 | -0.21 | -0.08 |

Source: Centennial Corporation
as a group would benefit (suffer?) together.) The best performing partnership of the three is the most recently formed. Yet, its IRR to the investor as of December, 1986 is only 7.8%, not much better than investing in existing properties. The other two partnerships, while older, do worse in terms of IRR with both yielding around 5%. The profitability index for all partnerships is negative. While the Capital Fund and Development Fund II have different IRR returns, the profitability index for the two RELPs is identical. Thus, by this return measure, the investor is equally worse off by investing in either fund versus a "risk-free" investment. It should be noted that the performance results include the residual value of the partnerships' interest in properties remaining in the portfolios. The actual return to the investor may differ from the returns shown in the exhibits.

The degree to which property development has proceeded among these partnerships varies with the age of the partnership but may not have an impact on the returns. In the Capital Fund, for example, seven of the eight land parcels have been developed, of which three have income-producing structures, and the IRR to the investor is only 5%. Three of the seven properties for Development Fund II have been developed although no building construction has occurred. For Development Fund
III, three of the eight properties have been improved. A portion of one of its three properties has been further developed with a retail center. Yet, even though the least developed of the three partnerships, the calculated return to the investor is the highest. It may be that this partnership acquired parcels with more appreciation potential than those acquired by the first two partnerships.

The difference in the returns may be due to the amount of leverage in the partnerships. By December, 1986, the Capital Fund and Development Fund II were leveraged at 65% and 38% respectively while Development Fund III was leveraged at only 21%. It could be that the cash requirements of the debt service for the first two RELPs consumed some of the value created through property sales and income thereby lowering returns. Even so, the first fund, with higher leverage, actually has performed somewhat better than the second though not by much. This may only be due to the longer life history of the first fund and inherently greater appreciation in its properties due to the passage of time.

In comparing the results of these two groups of partnerships, it appears that the returns to the investors certainly do not warrant investment in these RELPs. The higher risk factor of the land development RELPs does not seem to be
offset by higher returns versus the income RELPs. In relative terms, the two newer land funds have performed somewhat better than the income funds but this comparison is meaningless given the higher yields possible from other forms of investments. On the other hand, the lifespan of the land funds should be of shorter duration than the income funds. Value in land development is created through the efforts of the syndicator to improve property. Unless the objective is to "bank" the land for a period of time, development should commence immediately with results known within several years. Because these partnerships were not formed to bank land, the results for the Centennial partnerships, while slightly better than the Angeles partnerships, are worse relative to the "expectations" of returns. Looking at the residual values for the land funds, the efforts of the sponsor to increase value given the risk of land development have not enriched the investor to date. Of course, land development is more risky and perhaps the sponsor failed to create significant value in the properties. Yet, given the fast growth of the areas in which Centennial has acquired land, it seems more likely that the sponsor did not look after the investor but rather mismanaged the activities of the partnerships.

While the greater risk of land development did not return greater rewards to the investor for the Centennial investor, it
does not prove that this will always be the case. In fact, it appears that mismanagement is more likely a reason for the poor performance. The Recorp Companies (Phoenix, Arizona), a land syndicator sponsoring private partnerships, has, in the 15 land development partnerships formed and closed since 1983, yielded 280% on investor dollars with an average holding period of 9 months! Clearly, risk can be rewarded.
A. The Copley Experience

For more than 20 years, Copley Real Estate Advisors (Boston, Massachusetts) has invested in development equity partnerships assembling a portfolio of more than $4.5 billion in assets today. While Copley forms its RELPs with funds from institutions and wealthy individuals, its partnerships' strive to increase investor wealth through investment in developmental real estate. For this reason, it makes sense to explore their investment results and suggest how such strategy can be reproduced for the ordinary RELP investor.

Copley's strategy has been to place funds in differing phases of the development cycle as warranted by the risks and rewards. This risk is managed by evaluating different positions in the development cycle across a wide range of product further diversified by geography. Copley analyzes extensively major markets for opportunity and makes investments which meet internal criteria of risk and return. As part of
their strategy, they attempt to link-up with a few developers in each market who specialize in different product types, particularly suburban office, R & D, and industrial projects. These relationships are cultivated over time and provide a base of repeat business.

Quite simply, Copley subscribes to the belief that greater returns can be accomplished through taking risk of development versus merely acquiring property. According to Joe O'Connor, President of Copley, most investors expect that cash yields on development property, once in operation, should yield returns of 12.5% to 13% before leverage. The overall discounted yield or IRR should come in the range of 17% to 18%. Copley's historical track record indicates that they have bettered their own expectations.

For a sample of 40 completed joint venture projects representing the development of 500 properties of 23 million square feet since 1967, the average overall IRR equaled 23% for the investors. These properties were developed in conjunction with 22 developers in 12 different states, and include properties of at least four years of age with an average operating track record of under eight years. The range of IRR's to the investor for the 40 projects goes between a -5% return to nearly 80%. Surprisingly, Copley suffered a loss in
only one project out of the 40. In over 90% of the sample, the returns of the investments provided returns above a "risk-free" rate, the return which could have been realized by safer investments like high-grade corporate bonds.

When a smaller sample of 18 joint venture developments is examined for actual variance from both expected income and costs of development, the results show only small deviations. Shell costs, in 95% of the cases, came within plus or minus 10% of projections, with a mean variance of 2% for the entire sample. In a 17-year period, for $1 billion of development costs, actual shell construction costs came very close to projected costs. It should be noted that most of the projects are fairly simple office and industrial buildings with short construction periods. Soft costs, primarily interest expense and other non-direct development costs, showed a mean variance from projections of negative 6%. In most cases, the soft costs came in lower than projected at the outset of development. The mean variance for total development costs was a negative 1%. For 93% of the sample, total costs came in within plus or minus 10% of projected total costs.

The most important measure of return is the cash-on-cost yield of the development property. For the sample group, the average cash-on-cost yield equaled 15.7%. While 19% of the
sample had yields lower than projected, the remainder, 81%, had yields greater or equal to the initial projections of yield. Keeping in mind that Copley expects such yields to fall between 12.5% and 13%, their portfolio has performed better than their own expectations.

The upshot of Copley's experience indicates that the risk of development does not fall within the construction aspects of development. Construction costs, both hard and soft costs, have come very close to expected values. The greater risk, the one in which the developer has less control, comes in the lease-up phase. Yet, as the cash-on-cost yields show, Copley has done very well in managing this risk. Given the spread between a cash-on-cost yield of 15% and a market capitalization rate of 9% to 10%, Copley has certainly created value through development. For investors staying in such properties, once operating, the current yields should be quite high, higher than investing in such properties at the last stage of the development process.

The experience of Copley indicates that development equity joint ventures can provide substantial yields. The question remains whether such yields can be found for the RELP organized to invest in development deals. I maintain that it can be done. The manner in which Copley structures its investments
can be used as a framework for the RELP.

Copley structures its investments by requiring that its investment funds receive a priority return on cash from operations before sharing with the development partner. It splits the residuals 60% or more for investors with the balance to the development partner. For this split, Copley requires little or no invested cash on the developer's part. For matching investment funds with the capital needs of developers, Copley receives an asset management fee equal to 1% of the asset value. There is no reason a RELP sponsor could not structure the same terms or better. In fact, Copley has recently offered three public RELPs, known as Copley Realty Income Partners, which will be investing in joint venture developments. The terms of the deals are such that the sponsor receives a number of different fees. The largest fees come from acquisition and disposition fees, organization fees, on-going management fees as a percentage of cash flow, and a 15% share of the residuals. Investors get 99% of the cash flows, after the advisory fee, and 85% of the residuals. As an incentive to the investors, an 8% preferred return of invested capital, non-compounded, is included as part of the deal structure.

Copley's venture into the public marketplace is further
evidence of the argument of this thesis -- development equity syndications will become the next wave of offerings presented to the public. The next section of this chapter explains the development equity syndication and gives reasons why investors should be attracted to this type of RELP.

B. Explaining the Development Equity Syndication

The development equity syndication, like any other syndication, represents the aggregation of capital resources from a pool of investors. This capital pool, unlike most other syndications, is formed for the purpose of pursuing the development of land and/or buildings. Such investment can be made in a single or several development ventures. Achieving higher returns on invested capital becomes the sole reason for the existence of the development equity syndication. Because the security represents only the promise of performance with no historical record of returns, the risk to the investor is greater with this form of RELP. Accordingly, the returns should reflect the higher degree of risk taken.

Purpose

Investing equity capital in the development of land or new construction serves as the simple purpose of this kind of RELP.
The one important caveat of these deals shall be that the sponsor does not act as the developer but rather as an organizer and fiduciary to the investor. The actual development is carried out by a third party. Of course, this third party may be an affiliate of the sponsor but, for the purpose herein, the assumption shall be made that the sponsor and the developer represent separate groups. The RELP only serves as the capital pool which funds the development effort. The assumption is made that such capital pools can fund development at or below the cost of other sources of capital for the developer. Perhaps more important is the fact that the pool of capital exists and is accessible to the developer. While other sources may exist, there may be reasons, besides cost, that developers may want to participate with such a RELP. Access, control issues, and on-going relation factors may play a role in attracting developers to sponsors promoting such RELPs.

Real Estate Product and RELP Structure

The basic structure of the development equity syndication parallels the Copley model closely except that the sponsor's compensation may be calculated differently. The RELP acts as the single limited partner in one or many development projects with the developer partner(s). In essence, each project could
be considered as a joint venture between the RELP and the developer. The sponsor's role will always be to act as the general partner to the RELP and make all investment decisions. In some cases, the sponsor may also act as a general partner within the joint venture(s) as well. The sponsor will collect a fee for organizing and advising the partnership both for investment decisions and for providing on-going management of the project(s). At the dissolution of the joint venture(s) or upon any capital event, the partnership will split the profits or proceeds with the development partner, and the sponsor shall be entitled to a share of the partnership's profits. In those cases where the sponsor also acts as the general partner to the joint venture(s), the sponsor shall be entitled to a profit split outside of the partnership's profits as well.

The structure of the RELP can impact the returns to the investor. The first decision focuses on determining the stage of development in which the fund will invest. What kinds of risks will be included? For example, will the RELP invest in only those projects already having received government approvals or will this be part of the development program? Related to this will be the product type. If land, will only residential land be developed? Or, will the partnership seek to acquire land in which zoning changes will be needed to realize added value? Should specific investment objectives
limit the sponsor's activities? Should the fund specify its investments prior to offering or not?

For the land development fund, it would seem best to identify specific properties as part of the offering. This gives the investor a chance to evaluate the potential for the immediate development of the property. Because the sponsor must make such evaluation as part of the offering, pre-specification mitigates the investor's risk. Second, if the land does not need to be immediately developed, it can sit waiting for development while the sponsor organizes the RELP. On the other hand, the building development fund should be organized as a blind pool. The sponsor needs the freedom to pick and choose among between numerous possibilities for those developments will be most rewarding. The idea is to diversify risk of development through product and geographical distribution. While such a fund could be specified, the nature of the building development business is such that as opportunities appear quick evaluation for investment is needed. The time needed to identify such opportunities prior to the organization of the RELP may not permit for such a time lag if the RELP attempts to specify the properties.

The use of leverage also needs to be decided by the sponsor as well. Of course, leverage increases the risk to the
investor through default yet may provide for better returns. On the other hand, the use of leverage reduces the total amount of funds needed to complete the development. What might be the optimal decision?

The leverage answer depends on the nature of the underlying asset. In land development, if the property is to be held for some period prior to development, it makes more sense to avoid leverage and its cost. If the property is to be immediately developed, leverage provides for greater returns. For the building development partnership, the leverage question is moot. Simply stated, the cost of capital for a building constructed with all equity funds is prohibitive for the RELP. The returns demanded by the equity capital for taking this amount of risk eliminates the returns for the sponsor and development partner. (This is not to say that it cannot be done, however.) Rather, the partnership should use leverage to magnify the returns thereby providing incentives for both the sponsor and development partner to have an interest in a successful project.

The last decision will be whether the RELP will be public or private. If a large pool of funds is needed, the public vehicle might provide for greater distribution. The private syndication, while smaller, may provide for greater flexibility.
in terms of deal structure and lower costs for organization. For the land development RELP acquiring a large tract of land to be developed in stages, the public fund is likely to provide the large amount of dollars needed. With the larger tracts, the time required to organize the fund has less impact on the overall returns given the greater time horizon needed to develop large tracts. The private fund would permit the sponsor to acquire a smaller tract which will be developed immediately. The time necessary to organize the fund is much quicker and allows for faster action. The private fund may also permit the sponsor to take on tracts with greater risks; it may be more difficult to sell a partnership to the public where the risk of payback appears so great that the average investor would have no interest. For the building development fund, the public versus private decision may be easier. The building development fund is probably best organized as a blind pool and thus lends itself to the public market.

Returns to the Investor

The investor, sponsor, and the developer partner will all share in the profits of the venture, if any. What will be the distribution of the returns? Should the investors receive a preferred rate of return which might lower the return to the sponsor and developer should the performance be less than
anticipated? Does that destroy certain incentives for the development partner to remain in the project? Of course, the question of when will the returns be distributed also comes into play. Will the developed property be sold or held for investment? This, of course, impacts the projected maturity of the RELP.

Given that the investor is applying capital to a more risky investment, the investor should receive a preferred position in any distributions equal to an alternative "risk-free" rate. In this manner, the investor will feel that the RELP will offer at least this return which could be achieved through alternative investments. More importantly, the return of invested dollars at the "risk-free" rate should be considered as a cost of the deal, not a return paid out of profit. Profit returns should be split between the three groups in such a manner that each party has an interest in remaining in the project until completion. Most importantly, the developer should always feel that he has a stake in the project regardless of the ultimate performance. Splits should not be structured so that a minimum profit comes to the investors before the sponsor and developer. Whether or not the property is held once operating depends upon the motivations of the parties entering the venture. There is no "right" answer.
With such risk, why then should the development equity RELP gain favor with investors? First, for the same level of investment as any other RELP, the investor can expect a higher rate of return. While this return may not be achieved given the risk, the potential for a higher return exists. While other alternative investments (non-real estate) may also offer high yields, such yields only come with an associated degree of risk. The development equity syndication, while risky, offers an investment in a physical asset. This asset has value in and of itself; the funds go towards the ownership of the asset itself. While it is possible that this capital could be lost through foreclosure, proper selection and management can do much to avoid this risk. Moreover, the possibility of placing additional funds into the asset to delay foreclosure, while diluting ownership, can further protect the original investor from a complete loss. In a sense, the investor can give up a portion of the development profit, generally 20% to 25% above the development cost, to insure some portion of his investment.

Second, the development equity RELP permits the investor to get into choicer properties without competing with other buyers desiring ownership of such properties once completed. By getting into these properties at an earlier stage, an entire level of competition is eliminated. While the level of risk increases through earlier investment in the development phase,
the on-going return from operations increases as well, especially if the property performs as anticipated.

Third, when organized for the purpose of investing in the development of several properties, such diversification offsets non-systematic risk. The poor performance of one property or more can be offset against the better performance of other properties. Diversification does not protect against a general economic decline or other larger market forces but does protect against a few poor investments. The beauty of the RELP is that it allows the investor the ability to do so by purchasing one small security versus making a single, often large, direct investment in one development property. His risks become narrower through the pooling of funds with others.

Fourth, the investor places the management and oversight of his funds in the hands of professionals trained in evaluating and managing development properties. While the investor pays for this service through fees to the sponsor of the RELP, he need not have the knowledge and experience to participate in these kinds of ventures.

Fifth, the time duration necessary for determining whether or not a significant return can be realized should occur within a few years from the original investment. Once completed, a
value of the development can be ascertained through appraisal and, if the objective of the partnership is to dispose of properties upon completion, the investor will recognize his gain (or loss). RELPs which invest in existing properties often require the passage of seven or more years before dissolution and recognition of any gain or loss.

Finally, no tax events occur during the development period until the property is sold or enters operation. Thus, the investor need not be concerned with a tax payment occurring without a cash distribution during the period of his investment.

Sponsor Role in Management

While organizing a RELP presents its own difficulties, this effort does not require any skills distinct from organizing any other form of RELP. The on-going management of the sponsor combined with the requirement that the sponsor understand the development industry separates this kind of RELP from those investing in existing property. The sponsor must possess the skills to correctly evaluate and choose those developments in which the RELP will participate. Moreover, as the developments proceed, the sponsor needs to actively review the progress and take action as appropriate. This brings up
the immediate question of the role of the sponsor in the development process. Should the sponsor be a general partner with the developer or should the RELP invest as a sole limited partner? If the latter is the case, then the sponsor removes himself from the role of controlling the development. Would this be wise?

For both land and building development, the question of the sponsor's involvement as a general partner in the development joint venture depends on several criteria. For those partnerships assembled as public partnerships, the sponsor should only play the role of the general partner to the partnership, not to the ventures with third party developers. The rationale is simple -- the sponsor needs to act as a fiduciary to the limited partners and not subject its interest in the venture to liability which could endanger its control of the limited partnership. This rationale rests upon the fact that most public RELPs tend to be of considerable size and would probably invest in several development projects at once. For private RELPs, the decision rests on the size of the fund and the number of properties acquired. For a fund investing in one development property, it makes more sense that the sponsor play a more active role. After all, the assets of the partnership are invested in one property and its failure to perform wipes out the assets of the partnership anyway. If the
RELP invests in several properties, then the sponsor may not want to become a general partner in the ventures itself. Again, the sponsor would not want to expose its position in other properties of the RELP to any one development project.

Summary

Overall, the development equity RELP, while more risky, can offer greater returns. This paper has shown that investors in RELPs acquiring existing properties often do not receive a substantial cash return on their investment for a period of many years. Therefore, it makes sense for such investors to find interest in more speculative RELPs which do not offer any current income but can yield substantially more overall within a shorter time frame. As investors now focus on such cash returns, the development equity RELP should become a more desirable investment vehicle for those desiring real estate investments through this form of security.
Chapter One


Chapter Two


Chapter Three


2. ibid., p. 38.

3. ibid., p. 38.

4. ibid., pp. 35-36.

5. ibid., p. 34.


END NOTES

Chapter Four


2 Lynn and Goldberg, op. cit., p 177.


Chapter Five


2 Real Estate Report, PaineWebber Direct Investment Department, 1987 (Not available to the public).

3 Recorp Prior Performance, (Data as of February 1, 1987) Recorp Companies, Scottsdale, Arizona.

Chapter Six


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