Examining Liquidity in Non-Controlling Joint Venture Partnership Interests at the Asset Level

by

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Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

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ABSTRACT

Compared to traditional investment options, such as stocks and bonds, direct real estate investments are illiquid. This problem is magnified in joint venture partnerships. Non-managing member partnership interest holders typically do not have a way to dispose of their interest (thereby unlocking any residual value) prior to a capital event at the property level. Even with a forced sale mechanism included in the joint venture agreement (buy/sell agreement, ROFO, etc.), the non-managing member partnership interest holder is disincentived to exercise the option without the expertise to manage the investment. Depending on the long term strategy (buy/hold/sell) of the managing member, the non-managing member partnership interest could remain virtually illiquid over the entire holding period. The thesis will answer whether or not the non-managing member partnership interests can be transferred more efficiently (and, therefore, more fully valued prior to capital event) via specialized investment platform and, if so, what changes will need to be adopted in the market and within partnership agreements to facilitate such transfers. Specifically, this thesis will examine the feasibility of creating and implementing a new, market-creating enterprise that purchases and trades non-managing member partnership interests.

This topic is especially relevant today given the recent turmoil in the private real estate investment market and the prevalence of cash-strapped non-managing member partnership interest investors (institutions as well as individuals) seeking to unlock their wealth, as well as managing members desiring to preserve their ownership in real estate they believe will rebound with the market.

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Identifying the Need

Compared to traditional investment options, such as stocks and bonds, direct real estate investments are illiquid. This problem is magnified in joint venture partnerships where a non-managing member partner, usually a money partner without the requisite level of expertise or interest, teams up with a managing member partner, who manages the day to day aspects of the real estate investment. Non-managing member partnership interest holders typically do not have a way to dispose of their interest, thereby unlocking any residual value, prior to a capital event (i.e. liquidation or refinance) at the property level. Even with a forced sale mechanism included in the joint venture agreement (buy/sell agreement, ROFO, etc.), a non-managing member partnership interest holder is disincentived to exercise the option without the capability to operate the property. Depending on the long term strategy (buy/hold/sell) of the managing member, the non-managing member partnership interest could remain virtually illiquid over the entire holding period.

As a result of these illiquidity concerns and a lack of competition for non-managing member partnership interests (usually the only other potential buyers are the managing member or other non-managing member partnership interest holders), prospective non-managing member partnership interest buyers often value non-managing member partnership interests utilizing significantly higher discount rates than the underlying net asset value would imply. Interviewed sources cite transactions occurring between 80% and 20% of the current, market net asset value, with the bulk of the transactions occurring in the 30% to 50% discount range. A mechanism to increase competition in this arena, that would allow for the sale of these non-managing member partnership interests at a discount less than the typical 30% to 50%, would certainly be a
welcome option for holders of non-managing member partnership interests seeking to unlock long term invested wealth.

This topic is especially relevant today given the recent turmoil in the private real estate investment market and the prevalence of cash-strapped non-managing member partnership interest investors (institutions as well as individuals) seeking to unlock wealth and shore up balance sheets by quickly unwinding long term investments. Managing member investors desiring to preserve their ownership in real estate they believe will rebound with the market may also benefit from new partnerships with more liquid non-managing member partners who may also have greater faith in the project.

**Thesis Question**

This thesis will answer the question, whether or not the non-managing member partnership interests can be transferred more efficiently (and, therefore, more fully valued prior to capital event) via a specialized investment platform and, if so, what changes will need to be adopted in the market and within partnership agreements to facilitate such transfers. Specifically, this thesis will examine the feasibility of creating and implementing a new, market-creating investment vehicle.

**Methodology**

Data will be gathered via interviews with decision-makers on the non-managing member partnership interest side (institutional funds, and smaller, private investors), managing members (large institutions and entrepreneurs), secondary buyers of non-managing member partnership
interests, legal counsel, accountants, and others professionals as needed. Additional data and information will be sourced through relevant industry publications.

Non-managing member partnership interest investors will be questioned regarding their willingness to participate in the sale of non-managing member partnership interests, the motivation behind their desire to participate in such an exchange, how the added liquidity created by an investment vehicle will affect their inclination to enter into new joint ventures, how they price risk, what kind of protections they would desire, etc. They will be also queried for suggestions for the development and implementation of a fund focused on purchasing non-managing member partnership interests, marketing the benefits of such a fund, as well as current and proposed valuation techniques.

Managing members will be consulted regarding their concerns re maintaining control over assets, privacy, legal issues, and interest in participating in such a program. They will also share input on how they could become comfortable with any foreseeable challenges associated with a sale of non-managing member partnership interests as well as the benefits (to the managing member) of approving such transfers. They will be also queried for suggestions for the development and implementation of a fund focused on purchasing non-managing member partnership interests, marketing the benefits of such a fund, as well as current and proposed valuation techniques.

Secondary buyers of non-managing member partnership interests will provide expertise on how they value non-managing member partnership interests, and the risk/reward associated with the investments. Additionally, secondary investors in non-managing member partnership interests can share their expertise on how they are able to get around the legal issues associated
with transfers and make managing members comfortable with their involvement in each joint venture.

Legal counsel will identify transfer issues and other restrictions as well as suggest possible compromises to encourage a sale.

Others interviewees include entrepreneurs qualified to provide input on the fund structure and capital structure of the proposed business plan.

**Data Requirements**

To assess the viability of a secondary market for non-managing member partnership interests, the following information will be sourced from interview-based research:

- Estimated market size for non-managing member partnership interests to establish the scalability of such a business
- An understanding of the issues impacting non-managing member partnership interest values and marketability
- How/What value is created for non-managing member partnership interest holders and managing members upon the establishment of a secondary non-managing member partnership interest investment vehicle
- Historic and current legal issues associated with non-managing member partnership interest transfers as well as potential workarounds, compromises, opportunities, and improvements to facilitate future transfers
- Input regarding the marketing of a vehicle that specializes in the secondary acquisition of non-managing member partnership interests
• Fee/Revenue structure for a secondary non-managing member partnership interest investment vehicle

• Future potential iterations of a secondary non-managing member partnership interest investment vehicle once the initial concept becomes accepted and prevalent

**EVALUATING THE MARKET NEED**

**Seller Motivation**

Because a potential buyer will be targeting non-managing member partnership interests (as opposed to managing member partnership interests), the buyer will be unable to create additional value through operational improvements or the placement of additional leverage. As a result, the non-managing member partnership interest buyer may have to complete the purchase at a discount to the net asset value if the buyer’s target return is above what is offered by the proforma cash flow. Based on interviews with industry practitioners and professional service staff, when these transfers take place today, in a highly illiquid market, they typically trade at a 20% to 80% discount to the current, market net asset value, with the majority trading in the 30% to 50% discount range. Some examples of what may motivate the holder of a non-managing partnership interest to sell are as follows:

*Partnership Dispute Resolution*

In a joint venture involving multiple partners with the ability to block the sale of an asset, a number of the partners may wish to liquidate their interests, while one or more may prefer to
continue holding the real estate. The partner(s) who wishes to hold the real estate can use his position to obstruct the sale process (potential non-managing member partnership interest buyers rarely want to risk costly legal battles with disgruntled members of the existing party or wait for the selling partners to come to an agreement) and eliminate a potential source of liquidity for his partner(s). Alternatively, the partners can have a falling out and no longer wish to do business together. For example, the non-managing member partnership interest holder may not be receiving the reporting he desires, the managing member may not be communicating updates concerning the project with the non-managing member, the non-managing member may no longer have faith in the business plan, or the personal relationship has ended and they would prefer not to remain business partners. There are numerous other possibilities. Regardless of the dispute, without the possibility of a sale, the fastest and easiest method for the non-managing member to realize a portion of the asset’s value is to sell its interest to a new partner.

*Inability to Fund Capital Calls*

One risk inherent in any real estate investment is the possibility of additional capital calls. If unanticipated future cash inflows are required and the non-managing member interest holder is financially unable or unwilling to contribute additional capital to a project, he may wish to transfer his interest and realize some of the asset’s value, rather than face dilution after failing to meet a capital call. Pushed to an extreme, a potential non-managing member interest seller could risk defaulting on his obligation and undergoing a potentially lengthy, costly, and embarrassing legal battle unless a new partner can take his place. Selling the non-managing member partnership interest to a new entity could prove to be a valuable lifeline to the initial holder as
well as to the managing partner, who will welcome a new partner with deeper pockets, given that additional capital is necessary to effectively manage the asset.

**Lock In Gains**

A non-managing member investor may believe an asset has achieved its maximum value and/or a market has been overvalued and wish to lock in gains through liquidation. If the other partner(s) are more bullish on the asset or market and unwilling to acquiesce to the sale of the whole property, rather than wait for a resolution, the seller may wish to exit before the bubble bursts and values fall. A buyer of non-managing member partnership interests would be an avenue for the seller to quickly realize paper gains without the trials and delays of a potentially prolonged mediation between the other partners.

**Estate Planning**

For affluent families and individuals, estate planning is an important tool for the transfer of wealth between family members and generations after death. If it is the intent of the estate to maximize the value of the estate while maintaining equal value for the beneficiaries, the holder of an asset may choose to transfer ownership to the beneficiaries in equal, non-managing member partnership interests with the asset itself managed by a trustee (assuming the beneficiaries are unable to fairly manage the property themselves). Under United States tax law, upon the transfer of an estate’s real estate assets to its beneficiaries, the basis of the real estate is stepped up from the basis at acquisition to the then market value of the asset. Often, when that is the case, one or more family members may want to exit the investment in order to realize the value of the inheritance while minimizing the tax implications of a sale. When multiple
beneficiaries have equal ownership, disagreement over the sale of a property often erupts. By making a buyer of non-managing member partnership interests available to purchase these interests from the exiting family member, the seller can save on taxes and easily exit an undesirable investment without propagating discord within the family.

Changes to the Tax Code

Fear over anticipated changes to the tax law, such as the “Buffett Rule”, which recommends a minimum tax rate of 30% for all individuals earning over one million dollars per year, and proposed increases to the long-term capital gains tax rate may entice owners of property to liquidate investments sooner, while the tax consequences are less severe. One or more partners may be motivated to dispose of their interest for tax purposes, rather than basing a decision on the present and future economics of the project. Assuming the remaining partner(s) want to stay in the deal and are unable to buy out the selling partner at a satisfactory price, transferring the partnership interest to a new investor may be the ideal way to realize the value of the investment and avoid excess future taxation.

Dissatisfaction with the Project or Sponsor

An essential aspect of successful joint ventures is a relationship of mutual trust between the managing and non-managing partners. If that relationship is damaged, both groups of partners will likely wish to dissolve the partnership and go their separate ways. The relationship may become impaired due misrepresentations or omissions during the initial stages of the partnership (developing the business plan and fundraising), dissatisfaction with the status of the project due to delays, cost overruns, slow lease up, macroeconomic developments, a personal
conflict, or any other number of project/sponsor related concerns. Short of exiting the deal completely (selling the asset), which may be undesirable for a variety of reasons, such as if the property were mid-development or lease-up and there was still considerable potential value added, allowing one partner to sell his interest to another interested member may enable both partners to separate amicably and realize potentially more value for their investment through the transfer.

*Fund Life Conflicts*

Institutional investors with fixed fund lives, who partner with local operators to manage complex real estate investments (e.g. development projects, buildings with significant vacancy, or management intensive real estate, such as retail centers, boutique hotels, etc.), but lack the personnel or depth of experience to manage the assets internally, may also have need for a mechanism to unlock value, short of buying out their partner and installing a new managing partner, because their funds have reached the end of the investment period and no extensions are available. At the end of a fund, there may be one or a few assets which have struggled to sell due to economic conditions or have to overcome some unexpected capital improvement items as a condition of sale (during a period in which most or all of the fund’s free capital may have already been distributed). Basically, the non-managing partner may be forced to exit the investment due to non-real estate related, fund level issues. At the same time, the operating partner may not have similar fund life concerns and, instead, desires to stay in the deal in order to realize the full value of the investment. Further, he may the best operator to turn around and sell the asset. If that is the case, then the non-managing partner can sell the partnership interest to a new entity, thereby
freeing cash for distribution and leaving the managing member and new investor to realize the upside potential of the property.

**Portfolio Rebalancing**

For a non-managing member partnership interest investor with multiple assets and limited free cash, selling a non-managing member partnership interest to an outside buyer could realize liquidity quickly to fund other, more profitable (or loss-saving) investments. Examples of such investments include right-sizing an underwater mortgage to save a property from foreclosure or prevent other negative lender action, paying off a maturing loan, funding a tenant improvement that will create value, or purchasing a new, more profitable asset entirely. Or, on a more fundamental level, the sale of the non-managing member partnership interest could remove an unwanted asset from the seller’s portfolio, reduce the workload on personnel, and improve the balance sheet of the seller or its holding company.

**Other Liquidity Needs**

Undoubtedly, there are motivations for the holder of a non-managing member partnership interest to sell, other than those mentioned above. Fundamentally, the seller must be driven by the need for relatively quick capital and be without the ability to force a capital event at the property level.

**Why Would a Managing Member Approve?**

From the above, we can see that there are situations where non-managing member partnership interest holders may be motivated to sell below the net asset value. However, non-
managing member partners are just one piece of the puzzle. Because most joint venture agreements include managing member approval rights for the transfer of an interest to an outside party that is not preapproved, they can potentially stall or block the sale of non-managing member partnership interests. The managing member might be fearful that the new buyer will be attempting to wrest control of the asset through the non-managing member partnership interest. If the managing member believes that is the case, by approving the transfer, he risks losing control over the asset, a potentially very profitable management fee, and even his interest in the asset. Alternatively, the managing member may fear that the buyer of the non-managing member partnership interests will impose onerous reporting requirements or attempt to micromanage the project. The managing member may resist a new non-managing member partner in order to maintain flexibility throughout the project life so he can react quickly to market fluctuations and expedite important decisions. Given these concerns, what would motivate a managing member to approve a transfer and accept a new non-managing member partnership interest holder? The answers are as follows:

*Conditions of the Joint Venture Agreement Still Apply*

Despite the inclusion of a new non-managing member partnership interest holder, the same rights and remedies agreed to by the managing member and selling non-managing member partnership interest holder still apply. Assuming the agreement was constructed such that the managing member did not enter into an unfavorable contract and he is still happy with rights and privileges afforded him, the inclusion of a new non-managing member partnership interest holder should not affect the day-to-day requirements of his position or impair his ability to do his job. Further, the non-managing member partnership interest buyer cannot exercise any measures
that would damage the managing member’s ability to appropriately govern the asset or, taken further, to take over the asset, that were not already in the partnership agreement when the non-managing member partnership interest seller and managing member initially established a business relationship. So, approving the transfer of the non-managing member partnership interest does not weaken the managing member’s control over the asset.

*Preserving the Reputation of the Non-Managing Member Partnership Interest Buyer*

Any real estate investor or practitioner will tell you that the real estate investment community is extremely small. Often, you don’t need to go further than a phone call to legal counsel or friends in the industry to get all the information you need on a potential partner prior to beginning a business relationship. In rare instances where that first line of defense is inadequate, modern tools like LinkedIn or Facebook can enable you to easily find common relationships. Obtaining references is easier than ever before. As a result, it is more important than ever to maintain a pristine reputation in the industry. If a buyer of non-managing member partnership interests becomes known as a difficult or dishonest partner, the ability for the buyer to source future business will be dramatically impaired. This is particularly germane because of the approval rights for transfers retained by the managing member under the joint venture agreement, as mentioned above. Even if the sale of a non-managing member partnership interests would ultimately be found legally just, neither the seller nor the buyer would be happy or willing to engage in a prolonged and costly legal battle. Further, the non-managing member partnership interest buyer would be branded as an obstacle to managing members in all subsequent transactions, increasing the likelihood of future resistance to proposed transfers, slowing the eventual approval, and increasing the cost of all prospective transactions.
Reputational Risk to Managing Member Partner

Often, a managing member achieves funding for multiple deals utilizing the same pool of non-managing member investors. These investors are important sources of capital and of great value to the managing member for the reliability, ease, and consistency of their support. If, for whatever reason (perhaps one mentioned above), one of these non-managing member partnership interest holders wishes to exit a particular investment, but the managing member would like to salvage the relationship for the sake of the existing and future opportunities, the managing member would be inclined to approve the sale of the non-managing member partnership interest. Often, the non-managing member partnership interest will be marketed to the other non-managing members as well as to an outside group of potential buyers. While a managing member may prefer to transfer the interest to existing non-managing members rather than to an outside source, the managing member should be compelled to approve a transfer to the highest bidder for the non-managing member partnership interest, assuming the buyer has the financial wherewithal to replace the seller and preserve the strength of the partnership. Additionally, if the financial strength of the outside buyer improves the marketability of the partnership to lenders, that may cause the managing member to favor a transfer to that entity. Demonstrating his reasonableness will endear the managing member to the non-managing member partnership interest holder and put other non-managing member partnership interest holders at ease that they have an opportunity to exit a project if they need sudden, unexpected liquidity. This will also encourage future investment if non-managing member partnership interest holders know their investments are actually more liquid than with other, less understanding managing members.
**Duty to Stakeholders**

When entering into a joint venture partnership agreement, the managing member is expected to act in the best interest of the partnership. Obstructing or preventing a holder of a non-managing member partnership interest from selling the interest would be a breach of the managing member’s duty to the partners/partnership, if a transfer did not impact the viability of the project, assuming the sale would not trigger a default in the project and risk a loss of value to the other holders of non-managing member partnership interests. Therefore, the managing member is obliged to approve a sale of a non-managing member partnership interest, so long as it does not impact the feasibility and profitability of the project going forward.

**Exceptions**

The only instance where interviewees have universally rejected the idea of approving a transfer of non-managing member partnership interests has been if the proposed sale is to an industry competitor. The managing member’s fear is that a competitor will try to take control of the asset or, more likely, use information distributed by the managing member to the non-managing member partnership interest holders to better its position in the marketing and pricing of its assets. If that is the case, it is highly likely that the managing member will pursue all action afforded to it to prevent the sale of the non-managing member partnership interest to a new buyer/competitor. To avoid this potential conflict, a secondary buyer of non-managing member partnership interests will have to be a focused, non-competitive investment vehicle that poses no threat to the managing member.
Legal Issues

From a business perspective, there is a clearly defined need for liquidity in the secondary market for non-managing member partnership interests. However, what impact will current legal documents have on the viability of such a focused investment vehicle, given that older vintage deals, in an effort to comply with the “four factor” test, strictly prohibited transfer and newer documents, although modified, were based on these templates?

Prior to 1996’s “check the box” regulations, the tax status of different entities was determined via the four-factor test, which was created with the intention of preventing the structuring of investment vehicles and corporations to evade taxes. The classification of each business entity was based on the conclusion of four tests, concentrated on the resemblance test, which relies on objective entity characteristics to determine that entity’s tax treatment. Examples of such traits scrutinized under the four factor test are whether or not an owner would be held liable for the entity’s debts and whether or not the beneficial interest is transferable. At its core, the four factor test was designed to determine the traits of the business entity under investigation and, based on those independent qualities, assign a tax structure. In order to be classified as an entity with more favorable tax treatment (the tax treatment of real estate investment has always been a crucial factor in the industry), real estate joint ventures were structured such that transfers were legally very difficult. Incidentally, the four factor test, and the tax shelters it created, was a major contributor to the real estate boom in the 1980s.

In 1996, in an effort to reduce the complexity of the tax code (and, in part, due to dissatisfaction with the four factor test mechanism), the four factor test was replaced by the “check the box” regulations, which allowed the taxpayer to specify, via a simple tax form, how the business entity would be classified for tax purposes. The modification reduced the business
entity structuring burden on taxpayers and allowed for greater clarity regarding an entity’s classification. In the end, this simplification reduced the complexity of tax law. Unfortunately, real estate industry practitioners are historically biased towards using existing legal language (form documents) in partnership agreements and non-managing member partners did not push to revise the transfer provisions more aggressively. So, although they were no longer relevant from a tax structuring perspective, many of the transfer restrictions in place for tax purposes under the four factor test regime continued being employed after the passing of 1996’s check the box regulations.

Ultimately, the transfer restrictions are not legally necessary for tax purposes, but are commonly in use today. Further, if pushed, motivated non-managing members can pursue the managing member in court to approve a transfer and would likely prove victorious, depending on the state in which the business entity is located (although a prolonged and costly legal battle is not in anyone’s best interest). So, there are no significant legal hurdles preventing a non-managing member partnership interest holder from selling to a new buyer. The only potential hold up to a sale is a managing member resisting approval for a business reason. Examples of business reasons that may slow or prevent a sale of the non-managing member partnership interest are transfers to non-qualified buyers, transfers to competitors, or transfers to investors who may try to wrestle control from the existing managing member. Assuming these fears can be addressed and mitigated by the non-managing member partnership interest seller and buyer, transfers should be approved by the non-managing member.

One potential advantage of real estate’s traditionally slow transition to new forms of legal language is that a buyer of non-managing member partnership interests can target joint ventures of a vintage where non-managing members were able to demand strong reporting and control
rights from managing members. Good and accurate reporting will allow for greater transparency at the asset level and control rights provide incentive for the managing member to perform. These traits help ensure the success of the underlying investment in the acquisition of a non-managing member partnership interest.

**Marketing**

From the above, as well as interviews with industry professionals, there is a proven need for added liquidity in the secondary market for non-managing member partnership interests. Further, it is a concept that can be accomplished with legal documents currently in practice. However, the most challenging issue a new investment vehicle designed to purchase non-managing member partnership interests has to face is sourcing new opportunities. This is an especially pertinent concern given that many of the would-be sellers of non-managing member partnership interests are not always industry professionals aware of every liquidation option open to them. Further, there are very few investment vehicles focused on acquiring non-managing member partnership interests. So, owners of non-managing member partnership interests may not even be aware that there is such a market.

Based on conversations with interviewees, it seems that a multipronged approach to sourcing new investment opportunities is most appropriate. Initial methods for sourcing new investment opportunities are as follows:

*Direct Marketing to Non-Managing Member Partnership Interest Holders*

The most obvious way to generate new investment leads is to reach out to potential sellers of the non-managing member partnership interests directly. However, given that owners
of non-managing member partnership interests are in highly fragmented industries and sections of society, in order to reach a critical mass of candidates, the marketing materials must be broadly marketed. Examples of potential sources of advertising include the Wall Street Journal and Boston Business Journal. Full page ads cost $111,058 (non-contract, weekday rate) and $10,000, respectively, per a 7/8/12 search of wsjmediakit.com and www.bizjournalsmediakit.com. Additionally, a buyer of non-managing member partnership interests can utilize web-based advertising through websites such as Google and Facebook, which employ algorithms to specifically target individuals who may be interested in the product based on the key word searches they regularly employ. Finally, a buyer of non-managing member partnership interests can use a narrower method of search and make use of an internal network of professionals, friends, and family to identify and pitch prospective sellers. There are other possible methods as well. The above is just a sampling of direct marketing methods to holders of non-managing member partnership interests.

**Marketing to Managing Members**

In addition to pursuing opportunities directly through the owners of non-managing member partnership interests, a prospective buyer could also market the service to managing members. The managing member is usually among the first to know if a non-managing member partnership interest holder is looking to liquidate his position. Further, if the managing member is unable to provide the liquidity himself, at a price satisfactory to the non-managing member partnership interest holder, he may preserve any good will in their relationship by recommending the vehicle that invests in non-managing member partnership interests as a possible buyer. Ultimately, the managing member will free himself from an unhappy investor (which could risk
tainting his reputation among other current and future investors) and gain a new investor, happy at a low basis in the deal. At the same time, the managing member will have the same rights and privileges as afforded him in the original partnership agreement, unless the managing member and non-managing member partnership interest buyer decide to enter a new agreement, potentially re-aligning the partners’ interests in the deal. If the buyer is onboard, this may prove to be an opportunity for the managing member to adjust his basis in the deal and reopen himself up to a favorable promote.

Marketing to Legal Counsel

In tightly held investment communities, such as Boston, a handful of legal intermediaries touch the vast majority of real estate transactions. One interviewee posited a guess that the top five or six large firms acted as counsel for 80% of real estate transactions in the Greater Boston area. In environments such as this, pitching the utility of a vehicle that invests in non-managing member partnership interests to counsels would be a quick and easy way to indirectly inform a vast network of non-managing member partnership interest sellers of their options. Admittedly, there is no guaranty that counsel will inform his client of this option. However, trusted counsel often provides service beyond strictly legal help (such as playing matchmaker) and by making the would-be seller of a non-managing member partnership interest aware of a potential buyer, counsel could help the client achieve his liquidity goals. Another reason legal counsel is a strong potential promotional source is that they are often involved early on, when the non-managing member partnership interest holder is first examining sale options. Often, they know the non-managing member partnership interest holder is looking to sell even before the managing member is informed.
**Marketing to Financial Advisors for Wealthy Individuals**

Intimately familiar with their clients’ investment portfolios and return objectives, financial advisors’ value comes from their ability to maximize their clients’ investment returns adjusted for risk. Their recommendations on different investment options are seriously considered by clients and they are expected to be experts on every investment option and opportunity for their clients. As a result, non-managing member partnership interest holders seeking liquidity will often turn to their financial advisors for assistance identifying options. Educating financial advisors as to the benefits of selling non-managing member partnership interests to a new buyer would be a benefit to both parties. The financial advisor would help bring liquidity to a normally illiquid asset, potentially reinvesting that newly realized wealth into a less risky or higher returning vehicle, better suited to the client’s tastes. In return for this service, the non-managing member partnership interest buyer will get valuable new leads on motivated sellers.

**Marketing to Brokerage Community**

An obvious choice for assistance in marketing a new vehicle designed to purchase non-managing member partnership interests is the real estate brokerage community. Like financial advisors, real estate brokers (investment sales brokers as well as mortgage brokers) are expected to have a strong knowledge of all real estate market participants and their investment appetites. The value that they add and the reason they are compensated as a third party intermediary is their extensive network. Being able to connect holders of non-managing member partnership interests with serious, focused potential buyers is a valuable tool in their box and will make them more
desirable to non-managing member partnership interest sellers as matchmakers. This network runs both ways. Real estate brokers can be excellent sources of market intelligence for the buyer who specializes in non-managing member partnership interests as to who is looking to liquidate an attractive position.

*Marketing to Accountants*

Another group often relied on by the wealthy for help identifying investment opportunities is the accountant community. This is particularly true for specialized accountants, such as those that practice real estate accounting. Additionally, because they are acutely familiar with the asset-level economics of the investment, they can often recommend tax-advantaged avenues for sale. Making this group aware of a dedicated vehicle that invests in non-managing member partnership interests may help source new opportunities for investment. This will likely not be a major source of new deals, given that the accounting community is often reluctant to advise clients on investment options. However, in cases of extreme motivation to sell, this group can be a valuable wellspring of investment options.

*Marketing to Property Management Companies*

Another group with confidential knowledge of assets’ ownership and investment objectives is the property management community. Relationships with major property management companies can facilitate the identification and exploration of non-managing member partnership interests on behalf of a possible buyer. In most markets, this is a more diverse group and, therefore, may be a more challenging source of potential new leads. Additionally, there exists a potential conflict of interest, since property managers should not be
disclosing confidential client information. Consequently, property management companies are unlikely to be major sources of new business. However, they are worth exploring as a buyer of non-managing member partnership interests, as there are typically a few dominant players in each asset class and property size. If the investment vehicle is targeting a specific asset class or property size, this group may be helpful in isolating new opportunities.

Conferences and Industry Events

Because the secondary non-managing member partnership interest acquisition market is immature, there exists the opportunity for a new entrant to identify himself as an expert in the field. By speaking at industry events, publishing white papers, establishing a track record, and otherwise publicizing prowess in the specialty, an investment vehicle may be able to build credibility and potential sellers will, over time, begin to pursue that vehicle with new investment opportunities.

Other Sources

The above represents a sampling of some of the more likely deal sources for a buyer of non-managing member partnership interests. However, there are undoubtedly multiple other origins for deals that were not acknowledged. Often, deals are sourced in seemingly unlikely places by chance encounters: golf courses, restaurants, country clubs, gyms, etc. The above is not meant to be an all inclusive list.
**Competition**

The competitive field for secondary interests in non-managing member partnership interests is relatively small. Only two players participate in earnest. Madison International Realty, based in New York City, was founded in 1996 and specializes in “providing secondary equity capital for partner replacements and recapitalizations of Class A properties and portfolios located throughout the U.S., U.K., and Western Europe”, per their website, www.madisonint.com. Equity Resource Investments, based in Cambridge, MA, was founded in 1981 and “acquires, through partnerships that it manages, fractional real estate interests. The firm focuses on privately-held interests as well as special situation investments… [Equity Resource Investments] typically serve[s] as a capital partner with a limited role managing the real estate in which we invest. Our core expertise is assembling capital and sourcing, underwriting, and structuring off-market real estate transactions.”, per their website, www.equityresources.com. Both groups reportedly profited fantastically acquiring interests in non-managing member partnerships on the secondary market, particularly after the real estate recession of the early 1990s. Specifically, they targeted non-managing member partnership interests in real estate syndication deals from the pre-Tax Reform Act of 1986 era. Today, however, that market has severely diminished due to the ultimate liquidation of the invested real estate to new, non-syndicated buyers. Most holders of non-managing member partnership interests in syndicated deals are now secondary buyers waiting to realize the paper gains on their investments through liquidation, so much of the opportunity in this area has been realized. In order to grow their businesses, since the 1990s, Madison International and Equity Resource Investments have branched out from acquiring secondary non-managing member partnership interests in
syndicated deals to strategies that include secondary purchases of Tenant In Common interests and more traditional partnership recapitalizations.

Additionally, although neither Madison International nor Equity Resource Investments participate in this arena, there are select groups that specialize in and target the acquisition of Low Income Housing Tax Credits on the secondary market. However, this is a highly specialized niche, which is more focused on the tax considerations of the government issued bonds tied to the real estate than an actual real estate investment.

**Competitive Edge**

Given that there are already established firms in the business of buying non-managing member partnership interests on the secondary market, the next major hurdle in establishing the viability of a rival company is determining how it will be able to compete. Two ways in which a company could successfully compete are as follows:

*Target Multiple Sources of Non-Managing Partnership Interests*

Unlike some competitors, which target primarily 1980s vintage syndicated deals, Tenant In Common arrangements, or Low Income Housing Tax Credits, a new entrant would be wise to also pursue opportunities from other sources including “country-club” style joint venture partnerships, where a real estate operator funds investments through wealthy friends and family, and limited partnership interests in non-listed REITs. By doing so, an investment vehicle can draw from a wider net, build a robust investment pipeline, and potentially return more absolute dollars to investors. The only drawback is that the secondary purchase discounts (typically realized due to illiquidity) may not be as severe, given that the reporting requirements for these
investment types (particularly non-listed REITs) generally make them more transparent. So, the investment returns (from an IRR basis), may not be as strong as a fund targeting purely non-managing member partnership interests in syndicated deals, property held by Tenants In Common, and Low Income Housing Tax Credits.

Sourcing opportunities from a variety of different pools of non-managing member partnership interests is also important for the long term viability of the investment vehicle and follow up vehicles. Given that the supply of non-managing member partnership interests from syndicated deals is evaporating, the Tenant In Common market is small and highly bureaucratic (which makes effecting changes at the property difficult, such as raising new equity for capital improvements or refinancing the asset), and trading Low Income Housing Tax Credits is decidedly specialized, it would appear that none of these investment options provide ample enough opportunity for new competitive entrants to the market. In order to enjoy a successful future, other avenues for investment in the non-managing member partnership interest space must be considered by the venture.

Pricing

Interviewees estimate that buyers procure interests in non-managing member partnerships at discounts to current, market net asset value of between 20% and 80%, with the bulk of the transactions occurring in the 30% to 50% range. Generally speaking, the discounts vary depending on reporting transparency and legal rights of the non-managing member partnership interest holders. For example, a secondary buyer of a non-managing member partnership interest in real estate syndications will realize a higher discount to net asset value (40% or more) than a secondary buyer of a non-managing member partnership interest in non-listed REIT (20% to
40%) or joint venture where there are few non-managing members with strong reporting and control rights. If a new entrant to the market wished to quickly establish a reputation as a buyer of non-managing member partnership interests, acquisitions at discounts slightly below the market range may be an appropriate method to do so. Given the relatively wide spreads between the net asset value and realizable asset value of non-managing member partnership interests on the secondary market, there is still ample room for contracting the discount (to benefit the non-managing member partnership interest seller) while maintaining attractive pricing for the buyer of the non-managing member partnership interest.

Narrowing the discount at which a new buyer acquires a non-managing member partnership interest is vital to establishing a foothold in the business. Existing buyers with strong reputations as deal-makers and managing member friendly have a natural, non-financial advantage in sourcing new business. Managing members know the existing buyers and can trust them not to re-trade their deal with the current non-managing member partnership interest holder or to interfere with the managing members’ operation of the subject property. As a result, they are likely to receive the endorsement of the managing member. A new entrant into the non-managing member partnership interest buying field would have to deliver a compelling reason for holders to sell to them over an established brand that comes recommended by the managing member. The best motivation is economic; a higher purchase price, which means buying at a slightly lower discount to net asset value and realizing a slightly lower return. The holder of a non-managing member partnership interest may follow the path of least resistance and defer to the judgment of the managing member if two proposed purchase prices are the same. However, if the potential buyer without a recommendation from the managing member is offering a more attractive purchase price, the holder of the non-managing member partnership interest may be
more willing to push the managing member to accept a transfer. Later in the life of the investment vehicle, after developing a positive reputation in the secondary market for non-managing member partnership interests, the buyer can trade surety of amicable execution for discount and pricing can revert to market, evolving more favorably for the investment vehicle.

DEVELOPING THE BUSINESS PLAN

Based on the above, it is established that there is a need for liquidity in the non-managing member partnership interest market, transferring these interests is legally workable, investment opportunities can be effectively sourced, and that there are avenues to overcome the dominant competitors in the industry while still providing attractive returns to investors. The next stage of the analysis will focus on determining the feasibility of creating a new investment vehicle that specifically targets the acquisition of non-managing member partnership interests. In order to judge the value of the new investment vehicle, one must propose the ideal team structure, define capital sources for an investment vehicle, find the appropriate type and structure of investment vehicle, and calculate the profitability of the investment vehicle for the operator. If the investment vehicle is profitable for the operator on an ongoing basis, then the business will be considered viable.

Team Formation

Partnership Level

In order to attract capital from investors, a strong team with the requisite experience and discipline to identify and invest in favorable risk adjusted opportunities is absolutely imperative. The team must inspire confidence in its investors, through prior accomplishments and a
particular familiarity with secondary investment in non-managing member partnership interests. This is imperative at the partner level of the investment vehicle’s organizational chart. So, an investment vehicle’s ideal partnership structure will include two to three partners with experience in non-managing member partnership interest valuation, relationships with real estate joint venture managing members/operators as well as capital sources, and a legal expertise that specializes in partnership agreements. These partners must be confident in their ability and willing to take risks. Investors will likely require these individuals co-invest capital in the projects they recommend to ensure they have a vested interest in the success of the investment vehicle. Additionally, below market salaries will fortify investors’ belief that the principals are committed to the success of the investment vehicle.

Leadership with expertise in the valuation of non-managing member partnership interests on the secondary market is vital to ensure investors are not overpaying for their assets. The valuation experience this partner possesses will make him a key member of the management team and the individual of primary importance from the perspective of potential capital contributors in the investment vehicle. He, perhaps above all other partners, will be the “face” of the organization, and it is primarily upon the strength of his reputation that investors will be willing to finance the initial investment vehicle. In addition to investor relations, this individual will be extremely important during investment committees, determining the appropriate purchase price for individual non-managing member partnership interests on the secondary market. This person will also be familiar with the liquidity issues that accompany secondary investments in non-managing member partnership interests and help determine the appropriate market discount for different investments. Finally, it is his skill analyzing potential secondary investments in non-
managing member partnership interests that will be passed on to support staff to help scale the business, over time.

One or more partners must have positive, ongoing relationships with both real estate joint venture managing members and capital sources. The relationships with real estate joint venture managing members are important to generate new business and to alleviate potential concerns that the investment vehicle, as the new holder of the non-managing member partnership interest, will attempt to seize control from the managing member. As outlined in the marketing section above, managing members are an essential point of supply for identifying new investment opportunities and it is advantageous to have a preexisting relationship prior to the formation of a vehicle designed to purchase non-managing member partnership interests. Further, it will help shape the reputation of the firm, prior to actually developing a track record. If the reputation is positive, it could enable the firm to remain competitive on pricing with established, rival firms, rather than forcing the new vehicle to compete on pricing, as suggested in the competition section above. Constructive associations with capital sources are also of chief importance because a new business cannot succeed without seed investment capital to establish a track record. If potential investors are familiar and comfortable with the capabilities of one or more of the partners, they are more likely to invest in the investment vehicle. Further, these affiliations may also enable the partners to hit their target capital requirements more speedily and reduce the length of the business due diligence period. In summation, relationships with real estate joint venture managing members and potential capital sources will enable the investment vehicle to more quickly identify, evaluate, and finance new investments in non-managing member partnership interests.
Finally, at least one of the partners should be experienced reviewing and interpreting control provisions within partnership agreements. Liquidity, transparency, and control over decision making are among the primary drivers of value within secondary investments in non-managing member partnership interests. Given that joint venture agreements are typically unique to each partnership, the ability to quickly and accurately interpret the provisions is crucial to evaluating investments. Being aware of your rights and options as the holder of the non-managing member partnership interests is extremely valuable in making an investment decision. Further, given the potential quantity of investment opportunities, being able to rely on an individual’s skill in this area can become useful in screening non-starters within non-managing member partnership interests.

**Investment Support**

In addition to leadership with the skills and experience outlined above, support staff will be necessary to facilitate the speedy review of new investment opportunities and to monitor the performance of the assets on an ongoing basis. These tasks are generally not best performed by senior leadership and can be more cost effectively managed by one or two analysts and associates, less experienced but competent personnel. These individuals are extremely important to the speedy growth of the investment vehicle, but not experienced enough to form the face of the organization.

**Back Office Support**

Additional staff will provide the back office support. This will include accounting staff, who will prepare the required reporting to state and federal agencies as well as investors, and
administrative staff, who will manage the day to day aspects of office life. All together, the back office staff is anticipated to be one individual and then potentially build to two individuals upon expiration of the investment period of the follow up investment vehicle (Fund II).

**Fund Offering**

Assuming a successful track record of investment in non-managing member partnership interests is established, the formation of a fund to purchase non-managing member partnership interests is the next logical step in determining the viability of creating an investment vehicle that acquires non-managing member partnership interests. The fund must offer attractive overall risk adjusted returns to investors, while remaining competitive regarding market fees and the preferred return.

**Target Return**

Given that investments in non-managing member partnership interests are not considered traditional investments, this fund must offer an opportunistic yield. A target internal rate of return of approximately 25% is appropriate. Interviewees suggest this is a feasible yield for investments of this type.

**Fund Size**

Because the fund is targeting non-managing member partnership interests for investment and the most likely secondary sellers of these interests are high net worth individuals, the fund’s average investment size of $500,000 is assumed, with a probable range from $250,000 to
$2,000,000. Interviewees suggested fund sizes of no more than 50 times the average investment size, so total fund capitalization is assumed to be $25,000,000.

Given that the universe of potential secondary sales of non-managing member partnership interests is materially larger than the fund’s annual investment target, there should be ample opportunity to place this capital. Data from the 2007 Executive Summary Report On Partnership Re-Sale Discounts prepared by Partnership Profiles, Inc., which records the secondary market trades of non-listed, but publicly-registered real estate program units (or shares), indicates $1.3 billion of secondary sales occurred from 1994 through 2006, with secondary transactions averaging $55 million per year from 2000 to 2006. These figures do not include “country club” style joint ventures between wealthy family members and friends, which the investment vehicle would also target. Per MIT Professor David Geltner’s Fall 2011 Real Estate Finance and Investment lecture notes, the total capital committed to commercial real estate in the United States of America $8.9 trillion, of which approximately $5.6 trillion is not institutionally owned. So, there are considerable potential sources of investment for a vehicle specializing in non-managing member partnership interests.

*Leverage*

The fund will be unlevered at the fund level. The underlying real estate assets that the fund invests in can be levered as high as 90% loan-to-value. However, the fund will target a much lower average loan-to-value of 65%. This should enable the fund to pursue higher-yielding, opportunistic recapitalizations when attractive while encouraging an overall prudent, conservative strategy.
**Holding Period**

The target fund life will be ten years, consisting of an investment period of three years and a hold/disposition period of seven years. Because non-managing member partnership interest investments are highly illiquid and the secondary market is immature, it may be necessary to hold assets for duration of time greater than anticipated. As a result, the fund will include two one-year extension options at the General Partner’s discretion. If that is still not sufficient to dispose of remaining assets, at its option, the General Partner can transfer assets into follow up vehicles at a price determined by a consensus of third party appraisals. An advisory board, representing the fund’s limited partners, should be established to vet issues where conflicts could arise. Thereby, the assets of the first fund can be liquidated in a reasonable timeframe, but the subsequent fund and its investors can realize the full value of the investment upon sale of the underlying real estate.

As a result of the investment vehicle’s immersion into the secondary market for non-managing member partnership interests, it may be able to generate relationships with individuals and firms interested in the acquisition of non-managing member partnership interests. By quickly, opportunistically selling newly acquired non-managing member partnership interests to these groups, the investment vehicle can reduce the holding period of assets and boost the fund’s overall return.

**Management Fee**

Typical management fees for investment vehicles of this type are 1.00% to 1.50% of committed capital. Because of the relatively small fund size and the cost of administering to the day to day needs of the staff, a management fee at the higher end of the range is justified.
Additionally, the Limited Partners’ friendly promote structure (discussed below), which does not include a “catch up” period for the General Partner, where the General Partner receives a disproportionate share of the promoted return until reaching a targeted promoted return, provides valuable investment return for the Limited Partners. This should make the 1.5% management fee more palatable to the Limited Partners.

Other Fees

The fund’s fee structure also includes acquisition and disposition fees equal to 2.0% of the net real estate asset value. This is to compensate the fund for services related to acquiring and disposing of non-managing member partnership interests on the secondary market. Additionally, the fund will be reimbursed for third party expenses related to underwriting the acquisition or disposition of a non-managing member partnership interest. For example, this can include the cost of appraisals, engineering reports, environmental reports, etc. on the underlying real estate asset.

Return Structure

Capital will be repaid in the following order. First, Limited Partners in the fund will see 100% of their committed capital returned. Then, Limited Partners will receive 100% of the preferred return, which shall be equal to an IRR of 8.0%. After an 8.0% preferred return, the remaining return will be split such that the Limited Partner will receive 70% of the profits and the General Partner will receive 30% of profits, not including fees. As discussed in the management fee section, it is common for opportunity funds of this size to include a “catch up” period for the General Partner, where the General Partner receives a disproportionate share of the
promoted return until reaching a targeted promoted return. As a benefit to the Limited Partner and to encourage the General Partner to outperform, a “catch up” period has not been included in the fund’s promote structure.

**Summary**

Please see below, a summary of the fund’s specifications, for the convenience of the reader. These specifications will be used in the calculation that determines the fund’s profitability (later section):

- **Fund Size**: $25,000,000.00.
- **Target Return (IRR)**: 25.0%.
- **Leverage**: Un-levered at the fund level. Levered up to 90% at the property level.
- **Investment Period**: Approximately 36 months.
- **Hold/Disposition Period**: Approximately 84 months.
- **Total Anticipated Fund Life**: 10 years, with two one-year extensions.
- **Fees**:
  - *Management Fee*: 1.5%.
  - *Acquisition Fee*: 2.0%.
  - *Disposition Fee*: 2.0%.
  - *Expenses*: All expenses related to the acquisition and management of investments (third party fees, travel costs, etc.), but not the organization of the fund (fund-level accounting, office lease, etc.).
- **Preferred Return (IRR)**: 8.0%.
• **Promote**: Any return above 8.0% will be split 70% to the Limited Partners / 30% to the General Partner.

**Raising Capital**

When it comes to raising capital, there are typically three choices for firms to target: friends and family, high net worth individuals, and institutions. The feasibility of each option is discussed below in detail.

*Friends and Family*

While initial financing from friends and family may be the best option to purchase the first few secondary investments in non-managing member partnership interests and build a successful investment track record, it will be more challenging to raise $25,000,000 of capital in the same manner. Courting dozens of potential investors could take a long time. Making capital calls and distributions will be time consuming and logistically demanding. Responding to unsophisticated investor concerns over investment details could become burdensome and impair productivity. Finally, if the investment vehicle has over 100 investors, it would qualify as an investment company under the SEC and expose itself to onerous and costly reporting requirements. In conclusion, raising a fund of this size via friends and family is not ideal, but possible.

*High Net Worth Individuals*

High net worth individuals make for attractive capital providers for several reasons. They are able to make meaningful capital contributions, making the fundraising period shorter and less
stressful. High net worth clients are usually sophisticated (or represented by savvy individuals). Therefore, the intricacies of the investment strategy should be digested more smoothly than with friends and family. The strategy may be even more appealing to high net worth clients because they understand the value of liquidity in the secondary market for non-managing member partnership interests since they may hold non-managing member partnership interests or have experience trying to dispose of them. Typically, high net worth individuals are able to make allocations more quickly and with less arduous due diligence than their institutional counterparts. Investment offices tend to be more patient with their investments than friends and family or institutions, which is an important consideration given the illiquidity of investments in non-managing member partnership interests. This is because high net worth offices are classically more concerned with protecting the value of their holdings than rapid wealth creation. Additionally, high net worth clients do not normally require custom reporting, reducing the burden on the fund’s back office staff. Finally, the fund partners can likely source high net worth investors from within their own, personal networks or other channels such as conferences, eliminating the need for (and fees from) placement agencies. However, it is important to avoid raising capital via mass advertising, general solicitation, and “cold calling” to keep from violating federal Regulation D requirements, which prohibits such actions. For the reasons outlined above and more, funding the investment vehicle with capital from high net worth clients is an excellent option for the fund partners to pursue.

Institutions

Institutions, which include pension funds, endowments, insurance companies, etc., make up the final potential source for capital to finance the investment vehicle. Given the scale of most
institutions, it is not economical to make investments in funds at levels less than $10,000,000. Most institutions commit capital in increments of $20,000,000 or greater. Given these large contributions, in combination with the anticipated fund size and the fact that many institutional investment guidelines preclude themselves from constituting the majority of investment funds, most institutions would necessarily be unable to invest. Fortunately, this would not include the whole universe of institutional investors. Only a portion of the larger institutions would be prevented from investing due to scale. There are other, more nimble institutions with emerging manager investment directives that may be interested in an investment of this size. However, an additional hurdle is the investment product. Secondary investments in non-managing member partnership interests are not traditional investments for institutions. Convincing managers of the institution to invest outside of their customary real estate sources will be challenging, especially without a track record of institutional investment. Moreover, the due diligence required by institutions prior to allocating capital can be extremely demanding. Without ample time and staff, this can create an unwelcome and costly encumbrance on management. Even after receiving the due diligence items, institutions are notoriously slow allocating capital due to internal approval procedures. Because of time lost, spent preparing presentations and responding to inquiries by the institutional managers, fund managers may miss potentially profitable investments. For these reasons, the fund managers may prefer to focus fundraising efforts on high net worth individuals rather than institutional clients. However, even though it may be a more demanding process, if they believe an institutional investor might be able to add value or bridge a fundraising gap, fund managers may also include select institutions in their capital source targets.
Summary

High net worth clients fit neatly into the fund strategy, are nimble capital allocators, and do not require custom reporting, making them ideal candidates for the fund’s investor pool. Additionally, given the desired fund capitalization, fundraising from family and friends is a possible, though not optimal, source of investment capital. Conversely, the fund size makes it too small to attract most institutional capital. Coupled with long and intense due diligence and approval periods, fund managers have their own reasons to avoid institutions altogether.

Reporting

One area in which the investment vehicle can differentiate itself from its peers, and endear itself to its high net worth clients, is by offering friends and family or high net worth investors institutional-quality reporting. Private real estate investors typically do not enjoy the same sophisticated level of reporting that institutional investors require. Thorough and regular materials from the investment vehicle regarding the status of its investments and the pursuit of new opportunities will be a welcome sight to friends and family and high net worth investors and distinguish the investment vehicle from other prospective uses of capital.

Fund / Operator Profitability

To determine the overall profitability of the fund to the operators, three scenarios were prepared, based on the set of assumptions outlined below and different stages in the funds’ maturity. The first analyzes the leading fund (Fund I) on a standalone basis. See Appendix I: Leading Fund (1 Active), for more detail. The second scenario is the growth scenario, presenting a ten year proforma with three active funds, each subsequent fund starting at the expiration of the
investment period of the prior fund. In this ten year window, only one fund goes full cycle and realizes the complete promote. Fund II realized one year of the promote, $1,151,871. See Appendix II: Growth Stage Funds (3 Active), for more detail. In the final scenario, the three mature funds are fully invested and, over the ten year period analyzed, the promotes from each fund are realized and distributed. See Appendix III: Mature Funds (3 Active), for more detail. Analyzing these three scenarios together shows the prospective fund operator the point at which the investment fund(s) become profitable and help prepare the operator for the decision whether or not to pursue developing specialized investment vehicles targeting non-managing member partnership interests. The underlying assumptions for each scenario analysis, as well as conclusions as to the scenarios’ profitability are outlined in the following sections.

Leading Fund (1 Active)

As mentioned above, Appendix I: Leading Fund (1 Active), analyzes the profitability of operating a single fund on a standalone basis. To perform this analysis, the following inputs are assumed:

- The fund purchases assets at an average 40% discount to net asset value. This is consistent with feedback from interviews which stated typical discount to current, market net asset value ranges from 30% to 50%, and extremes of 20% to 80%. This is further supported by data from the 2007 Executive Summary Report On Partnership Re-Sale Discounts prepared by Partnership Profiles, Inc., which records the secondary market trades of non-listed, but publicly-registered real estate program units (or shares). This report cites discounts to net asset values ranging from 1993 to 2007 of 21% to 48%, with an average of 31% and median of 28%. The net asset values used by Partnership Profiles,
Inc. are calculated based on a combination of internal valuations by general partners, independent valuations by third party appraisers, and unit values determined by The Valuations Group, which specializes in valuing minority interests in public and private limited partnerships. Interviewees suggest that non-listed REITs are the most liquid form of non-managing member partnership interests and conclude that “country club” style investments, that the investment vehicle would also be targeting, will trade at significantly higher discounts to net asset value. Specifically, interviewees suggested discounts of approximately 50%, with positive or negative variances depending on the quality of the underlying asset and its financial structure.

- Initial yield of 10%. The appropriate initial yield is a more challenging metric to isolate due to the variety of deal types the investment vehicle may choose to target. However, because assets will be acquired at material discounts to net asset value from both non-listed REITs and “country club” style structures, a 10% initial yield seems to be a reasonable assumption. By way of support, from 2000 to 2007, Partnership Profiles, Inc. reports average yields ranging from 6.8% to 9.5% (average 8.3%) for low leverage, non-listed REITs and 4.4% to 7.7% (average 6.1%) for moderate to high leverage, non-listed REITs. The yields should be more dramatic for “country club” style investments, due to the more significant discounts at which the investment vehicle will be acquiring the non-managing member partnership interests.

- Inflation of 3%. The net asset value of the holdings is anticipated to grow at 3%, as well as yield from the investments. Expenses, which will be discussed in more detail later, are anticipated to grow at 3%, unless otherwise indicated.
• The terminal value of the fund’s non-managing member partnership interest investments is assumed to be at 100% of the current, market net asset value at the date of acquisition, grown at 3% per year until disposition.

• Year 1 Expenses are assumed to be the following:
  o Salary of $100,000 per year for two partners and $75,000 per year for two analyst/support staff. The partner salaries are below market to signal to fund investors that the partners are committed to the future returns of the fund.
  o Benefits are expected to cost 30% of their salaries.
  o Rent is anticipated to be $25 per square foot, with 1,500 square feet of office space.
  o Travel is underwritten at $50,000 per year.
  o Miscellaneous office expenses are anticipated to be $50,000 per year.
  o Please note that investments due diligence expenses are to be reimbursed by the fund and included in the cost of acquisition. Therefore, the expense is not included as fund expenses.

Based on these assumptions, as well as the fund specifications outlined in prior sections, it is anticipated that the fund will not be profitable during Years 1-6, with cash flow decreasing from ($50,833) in Year 1 to ($169,721) in Year 6. Cash flow turns positive in Year 7 at $965,808 and peaks at $2,639,001 in Year 8 before settling to $2,161,763 in Year 10. The fund averages $740,697 in income per year. However, this is misleading because the bulk of that income is earned at the end of the fund life. A fund operator anticipating only one investment vehicle will have to be very confident in the business plan, and willing to invest $668,386 of capital during
Years 1-6, to create the fund. With total profit over 10 years of $7,406,974 and the investment not being profitable at all until Year 7, this is a fairly risky investment for the fund operator. At worst, if the fund does not realize the promote and no subsequent vehicles are created, the fund operator will never earn a profit. Therefore, a fund operator planning only a single fund would not be well advised to pursue this investment.

**Growth Scenario**

As mentioned above, Appendix II: Growth Stage Funds (3 Active), analyzes the profitability of operating a total of three funds, each new fund being formed after the expiration of the prior fund’s investment period. This represents the growth stage (Years 1-10) of a fund operator looking to develop a series of investment vehicles. Similar to the prior example, to perform this analysis, the following inputs are assumed:

- The fund purchases assets at an average 40% discount to net asset value. This is consistent with feedback from interviews which stated typical discount to current, market net asset value ranges from 30% to 50%, and extremes of 20% to 80%. This is further supported by data from the 2007 Executive Summary Report On Partnership Re-Sale Discounts prepared by Partnership Profiles, Inc., which records the secondary market trades of non-listed, but publicly-registered real estate program units (or shares). This report cites discounts to net asset values ranging from 1993 to 2007 of 21% to 48%, with an average of 31% and median of 28%. The net asset values used by Partnership Profiles, Inc. are calculated based on a combination of internal valuations by general partners, independent valuations by third party appraisers, and unit values determined by The Valuations Group, which specializes in valuing minority interests in public and private
limited partnerships. Interviewees suggest that non-listed REITs are the most liquid form of non-managing member partnership interests and conclude that “country club” style investments, that the investment vehicle would also be targeting, will trade at significantly higher discounts to net asset value. Specifically, interviewees suggested discounts of approximately 50%, with positive or negative variances depending on the quality of the underlying asset and its financial structure.

- Initial yield of 10%. The appropriate initial yield is a more challenging metric to isolate due to the variety of deal types the investment vehicle may choose to target. However, because assets will be acquired at material discounts to net asset value from both non-listed REITs and “country club” style structures, a 10% initial yield seems to be a reasonable assumption. By way of support, from 2000 to 2007, Partnership Profiles, Inc. reports average yields ranging from 6.8% to 9.5% (average 8.3%) for low leverage, non-listed REITs and 4.4% to 7.7% (average 6.1%) for moderate to high leverage, non-listed REITs. The yields should be more dramatic for “country club” style investments, due to the more significant discounts at which the investment vehicle will be acquiring the non-managing member partnership interests.

- Inflation of 3%. The net asset value of the holdings is anticipated to grow at 3%, as well as yield from the investments. Expenses, which will be discussed in more detail later, are anticipated to grow at 3%, unless otherwise indicated.

- The terminal value of the fund’s non-managing member partnership interest investments is underwritten at 100% of the net asset value at the date of acquisition, grown at 3% per year until disposition.

- Year 1 Expenses are assumed to be the following:
• Salary of $100,000 per year for two partners and $75,000 per year for two analyst/support staff. The partner salaries are below market to signal to fund investors that the partners are committed to the future returns of the fund. In Year 6, after proving the value of their investments, it is assumed that the partners’ salaries will increase by $150,000 each and a new support staff member is hired at a salary of $80,000 per year to assist with reporting and back office support.

• Benefits are expected to cost 30% of their salaries.

• Rent is anticipated to be $25 per square foot, with 1,500 square feet of office space. In Year 6, with the addition of a new team member, the team is expected to occupy 2,000 square feet of office space.

• Travel is underwritten at $50,000 per year. In Year 6, the expense increases to $75,000 per year.

• Miscellaneous office expenses are anticipated to be $50,000 per year. In Year 6, the expense increases to $75,000 per year.

• Please note that investments due diligence expenses are to be reimbursed by the fund and included in the cost of acquisition. Therefore, the expense is not included as fund expenses.

Like the Leading Fund example, this investment analysis shows negative cash flow at the early stage. However, cash flow from the funds turns positive earlier, in Year 4. Although, like before, margins are thin through Year 6, the addition of the fee and promote income from Fund II and Fund III in Year 4-10 proves beneficial to the fund operator’s bottom line. Over the 10 year period, the fund operator earns $10,315,074, an average of $1,031,507 per year. This is a
somewhat more profitable investment for the fund operator, even with the addition of bonuses not included in the analysis (often, funds will offer an interest in the promote to employees to encourage retention and offset smaller salaries during the initial, fund formation stage). With this level of income, an enterprising fund operator may consider the formation of these types of investment vehicles.

*Mature Funds*

As mentioned above, Appendix III: Mature Funds (3 Active), analyzes the profitability of operating a total of three funds, each new fund being formed after the expiration of the prior fund’s investment period, starting in Year 7 of Fund I. This represents the mature stage of the fund operator, where the promotes of each investment vehicle are ready for harvest, over the 10 year analysis period. Similar to the prior example, to perform this analysis, the following inputs are assumed:

- The fund purchases assets at an average 40% discount to net asset value. This is consistent with feedback from interviews which stated typical discount to current, market net asset value ranges from 30% to 50%, and extremes of 20% to 80%. This is further supported by data from the 2007 Executive Summary Report On Partnership Re-Sale Discounts prepared by Partnership Profiles, Inc., which records the secondary market trades of non-listed, but publicly-registered real estate program units (or shares). This report cites discounts to net asset values ranging from 1993 to 2007 of 21% to 48%, with an average of 31% and median of 28%. The net asset values used by Partnership Profiles, Inc. are calculated based on a combination of internal valuations by general partners, independent valuations by third party appraisers, and unit values determined by The
Valuations Group, which specializes in valuing minority interests in public and private limited partnerships. Interviewees suggest that non-listed REITs are the most liquid form of non-managing member partnership interests and conclude that “country club” style investments, that the investment vehicle would also be targeting, will trade at significantly higher discounts to net asset value. Specifically, interviewees suggested discounts of approximately 50%, with positive or negative variances depending on the quality of the underlying asset and its financial structure.

- **Initial yield of 10%.** The appropriate initial yield is a more challenging metric to isolate due to the variety of deal types the investment vehicle may choose to target. However, because assets will be acquired at material discounts to net asset value from both non-listed REITs and “country club” style structures, a 10% initial yield seems to be a reasonable assumption. By way of support, from 2000 to 2007, Partnership Profiles, Inc. reports average yields ranging from 6.8% to 9.5% (average 8.3%) for low leverage, non-listed REITs and 4.4% to 7.7% (average 6.1%) for moderate to high leverage, non-listed REITs. The yields should be more dramatic for “country club” style investments, due to the more significant discounts at which the investment vehicle will be acquiring the non-managing member partnership interests.

- **Inflation of 3%.** The net asset value of the holdings is anticipated to grow at 3%, as well as yield from the investments. Expenses, which will be discussed in more detail later, are anticipated to grow at 3%, unless otherwise indicated.

- **The terminal value of the fund’s non-managing member partnership interest investments is underwritten at 100% of the net asset value at the date of acquisition, grown at 3% per year until disposition.**
• Year 1 Expenses are assumed to be the following, in order to be consistent with prior Appendices:

  o Salary equal to Year 7 of Appendix II: Growth Stage Funds (3 Active), a total of $797,146, with two partners and three support staff members, to assist with reporting and back office support.

  o Benefits are expected to cost 30% of their salaries.

  o Rent is anticipated to be equal to Year 7 of Appendix II: Growth Stage Funds (3 Active), at $38.63 per square foot, with 2,000 square feet of office space.

  o Travel is underwritten at $77,250 per year.

  o Miscellaneous office expenses are anticipated to be $77,250 per year.

  o Please note that investments due diligence expenses are to be reimbursed by the fund and included in the cost of acquisition. Therefore, the expense is not included as fund expenses.

Like the Growth Scenario example, this investment is profitable. Over the 10 year period, the fund operator earns $22,185,259, an average of $2,218,526 per year. This is a profitable investment period for the fund operator, even with increases to salaries or the addition of bonuses not included in the analysis (often, funds will offer an interest in the promote to employees to encourage retention and offset smaller salaries during the initial, fund formation stage). An enterprising fund operator should consider the formation of these types of investment vehicles, assuming the intent of developing economies of scale.
CONCLUSION

Real estate, non-managing member partnership interests in particular, remain an illiquid asset class. However, the development of a specialized investment vehicle that explicitly targets the acquisition of non-managing member partnership interests on the secondary market can help make these interests more tradable. Based on interviews with industry participants, there is a real market desire for a product that will allow holders of non-managing member partnership interests to exit their holdings at will. The vast majority of the managing member universe is willing to approve transfers to qualified, non-hostile, non-competitive secondary buyers of the interests. Legally, the transfers are easily approved if the managing member, non-managing member partnership interest seller, and non-managing member partnership interest buyer can agree on business terms. The most challenging hurdle to the formation of a new investment vehicle is sourcing new business opportunities, which can be accomplished through a variety of means including marketing to managing members and industry professionals such as lawyers, accountants, and wealth managers. There is ample room for a new market entrant to the non-managing member partnership interest acquisition space to differentiate himself and make lucrative investments. Further, an investment vehicle that specifically targets these assets can be profitable. Although, without scale (multiple investment vehicles), becoming a fund operator that specializes in this asset class may only be appealing to the less risk averse. A single $25 million fund is not profitable until Year 7 and returns only $7,406,974 to the operator by Year 10. It also requires that partners work for reduced salaries. A series of three funds, during the growth stage, becomes profitable in Year 4 and returns $10,315,074 to the Operator by Year 10. It too, requires the partners work for reduced salaries for five years. However, once the funds enter their mature stages, they become a worthwhile investment for the fund operator. With full salaries, the fund
operator earns $22,185,259 over ten years. It is not a suitable investment for a fund operator looking to profit from a single fund, given the high initial cost and risk of not realizing the promote. However, a scaled series of investment vehicles that target non-managing member partnership interests on the secondary market is a viable and potentially lucrative business opportunity for an enterprising operator with a long investment horizon.
Bibliography


Lee, B. (2012, July 5). Director, Beacon Communities. (M. DePucchio, Interviewer)


## APPENDIX I: LEADING FUND (1 ACTIVE)

<table>
<thead>
<tr>
<th>Fund Period Assumptions</th>
<th>Fund Specifications</th>
<th>Asset Acquisition Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment Period</td>
<td>Fund Size $25,000,000</td>
<td>Average Discount to NAV 40%</td>
</tr>
<tr>
<td>Hold/Disposition Period</td>
<td>Management Fee 1.50%</td>
<td>Inflation 3%</td>
</tr>
<tr>
<td></td>
<td>Acquisition Fee 2.0%</td>
<td>Terminal Value (% of NAV) 100%</td>
</tr>
<tr>
<td></td>
<td>Disposition Fee 2.0%</td>
<td>Property Level Expense Reimbursement 102%</td>
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### Year 1 - 10

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<th>6</th>
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</table>

### Fund Operating Cash Flow

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<tr>
<th>Acquisition Cost</th>
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<th>$ (8,333,333)</th>
<th>$ (8,333,333)</th>
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<tbody>
<tr>
<td>Investment Cash Flow</td>
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<td>$ 1,691,667</td>
<td>$ 2,575,750</td>
<td>$ 2,653,023</td>
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<tr>
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<td>$ 2,732,613</td>
<td>$ 2,834,592</td>
<td>$ 1,932,686</td>
<td>$ 663,556</td>
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<tr>
<td>Terminal Value</td>
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<td>$ 6,900,441</td>
<td>$ 7,107,454</td>
<td>$ 7,320,678</td>
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<td>$ 7,540,298</td>
<td>$ 7,766,507</td>
<td>$ 7,999,502</td>
<td></td>
</tr>
</tbody>
</table>

### Total Fund Cash Flow

| $ (8,333,333) | $ (7,500,000) | $ (6,641,667) | $ 9,275,207 | $ 9,553,463 | $ 9,840,067 | $ 10,135,269 | $ 9,472,984 | $ 8,430,063 | $ 7,999,502 |

### Fund IRR

| 25.67% |

### Fund Multiple

| 2.88 |

### Distributions

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<tr>
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<th>$ 1,386,667</th>
<th>$ 2,164,267</th>
<th>$ 2,337,408</th>
<th>$ 1,782,384</th>
<th>$ 1,160,698</th>
<th>$ 466,348</th>
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<tr>
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<td>$ -</td>
<td>$ -</td>
<td>$ (6,555,008)</td>
<td>$ (1,782,384)</td>
<td>$ (1,160,698)</td>
<td>$ (466,348)</td>
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<tr>
<td>Preferred Return Owed And Unpaid</td>
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<tr>
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<td>$ -</td>
<td>$ -</td>
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<td>$ 1,772,079</td>
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<td>$ 8,430,063</td>
<td>$ 7,999,502</td>
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### Capital Account

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<th>$ 25,000,000</th>
<th>$ 22,729,801</th>
<th>$ 14,508,721</th>
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<td>Disposition</td>
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<td>$ -</td>
<td>$ -</td>
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<td>$ (7,771,079)</td>
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<td>$ (5,829,352)</td>
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<td>Ending Balance</td>
<td>$ 8,333,333</td>
<td>$ 16,666,667</td>
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<td>$ 22,729,801</td>
<td>$ 14,508,721</td>
<td>$ 5,829,352</td>
<td>$ -</td>
</tr>
<tr>
<td>Remaining Cash Available for Distribution</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ 8,393,569</td>
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### Promote

| Split Investor | $ - | $ - | $ - | $ - | $ - | $ - | $ 2,687,699 | $ 6,631,089 | $ 5,905,044 | $ 5,599,652 |
| Split Sponsor (Fund) | $ - | $ - | $ - | $ - | $ - | $ - | $ - | $ 1,153,871 | $ 2,841,895 | $ 2,529,019 | $ 2,399,851 |

### Fund Level Fee Income

| Management Fee | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 | $ 375,000 |
| Acquisition Fee | $ 166,667 | $ 166,667 | $ 166,667 | $ - | $ - | $ - | $ - | $ - | $ - |
| Disposition Fee | $ - | $ - | $ - | $ 133,989 | $ 138,009 | $ 142,149 | $ 146,454 | $ 150,805 | $ 155,330 | $ 159,905 |
| Total | $ 541,667 | $ 541,667 | $ 541,667 | $ 508,989 | $ 512,009 | $ 517,249 | $ 521,424 | $ 525,806 | $ 530,330 | $ 534,905 |

### Fund Level Total Income

| $ 541,667 | $ 541,667 | $ 541,667 | $ 508,989 | $ 512,009 | $ 517,249 | $ 1,673,284 | $ 3,367,701 | $ 3,058,349 | $ 2,934,045 |

### Fund Level Expenses

| Employee Salary | $ 350,000 | $ 360,500 | $ 371,315 | $ 382,454 | $ 393,938 | $ 405,746 | $ 417,948 | $ 430,460 | $ 443,370 | $ 456,873 |
| Employee Benefits | $ 105,000 | $ 108,150 | $ 111,395 | $ 114,786 | $ 118,376 | $ 121,724 | $ 125,375 | $ 129,137 | $ 133,011 | $ 137,005 |
| Rent | $ 37,500 | $ 38,625 | $ 39,784 | $ 40,977 | $ 42,207 | $ 43,473 | $ 44,777 | $ 46,120 | $ 47,504 | $ 48,929 |
| Travel | $ 50,000 | $ 51,500 | $ 53,045 | $ 54,636 | $ 56,275 | $ 57,964 | $ 58,703 | $ 61,494 | $ 63,339 | $ 65,230 |
| Office Misc. | $ 50,000 | $ 51,500 | $ 53,045 | $ 54,636 | $ 56,275 | $ 57,964 | $ 58,703 | $ 61,494 | $ 63,339 | $ 65,230 |

### Fund Level Total Expenses

| $ 592,500 | $ 620,275 | $ 628,583 | $ 647,441 | $ 666,846 | $ 686,870 | $ 707,476 | $ 728,700 | $ 752,061 | $ 773,078 |

### Fund Operating Cash Flow

| $ (50,833) | $ (68,608) | $ (86,917) | $ (138,452) | $ (153,855) | $ (169,721) | $ 965,808 | $ 2,639,001 | $ 3,208,788 | $ 2,161,763 |
## APPENDIX II: GROWTH STAGE FUNDS (3 ACTIVE)

### Fund Period Specifications

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<tr>
<th>Year</th>
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<th>7</th>
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<tbody>
<tr>
<td><strong>Fund I Operating Cash Flow</strong></td>
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</tr>
<tr>
<td>Acquisition Cost</td>
<td>$(8,333,333)</td>
<td>$(8,333,333)</td>
<td>$(8,333,333)</td>
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<tr>
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<td>$1,666,667</td>
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<td></td>
</tr>
<tr>
<td>Terminal Value</td>
<td>$ -</td>
<td>$ -</td>
<td>$6,666,667</td>
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</tr>
<tr>
<td>Total Fund I Cash Flow</td>
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<td>$(6,666,667)</td>
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<tr>
<td><strong>Fund II Operating Cash Flow</strong></td>
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<tr>
<td>Terminal Value</td>
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<td>Total Fund III Cash Flow</td>
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</tr>
</tbody>
</table>

### Distributions

- **Preferred Return**: Preferred Return Earned, Preferred Return Paid, Preferred Return Owed And Unpaid
- **Capital Account**: Beginning Balance, Capital Returned, Ending Balance
- **Promote (Fund I)**: Split Investor, Split Sponsor (Fund I)
- **Promote (Fund II)**: Split Investor, Split Sponsor (Fund II)
- **Promote (Fund III)**: Split Investor, Split Sponsor (Fund III)

### Fund I Level Fee Income

<table>
<thead>
<tr>
<th>Management Fee</th>
<th>Acquisition Fee</th>
<th>Disposition Fee</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$375,000</td>
<td>$166,667</td>
<td>$166,667</td>
<td>$641,667</td>
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</table>

### Fund II Level Fee Income

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<thead>
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<th>Acquisition Fee</th>
<th>Disposition Fee</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>$375,000</td>
<td>$166,667</td>
<td>$166,667</td>
<td>$641,667</td>
</tr>
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### Fund III Level Fee Income

<table>
<thead>
<tr>
<th>Management Fee</th>
<th>Acquisition Fee</th>
<th>Disposition Fee</th>
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</tr>
</thead>
<tbody>
<tr>
<td>$375,000</td>
<td>$166,667</td>
<td>$166,667</td>
<td>$641,667</td>
</tr>
</tbody>
</table>

### Fund Level Total Income

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<thead>
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<th>Fund II</th>
<th>Fund III</th>
<th>Total</th>
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<td>$541,667</td>
<td>$541,667</td>
<td>$1,624,994</td>
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### Fund Level Expenses

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<td>$544,000</td>
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### Fund Level Total Expenses

<table>
<thead>
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<th>Fund I</th>
<th>Fund II</th>
<th>Fund III</th>
<th>Total</th>
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<tbody>
<tr>
<td>$541,667</td>
<td>$541,667</td>
<td>$541,667</td>
<td>$1,624,994</td>
</tr>
</tbody>
</table>

### Fund Operating Cash Flow

| (50,833) | (68,000) | (86,317) | (209,150) | (1,191,254) | (2,994,516) | (5,647,468) | 3,468,308 |
### APPENDIX III: MATURE FUNDS (3 ACTIVE)

<table>
<thead>
<tr>
<th>Year</th>
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<th>3</th>
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<tbody>
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<td><strong>Fund III Operating Cash Flow</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Acquisition Cost</td>
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<td>$ (8,333,333)</td>
<td>$ (8,333,333)</td>
<td>$ -</td>
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<tr>
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<td>$ 2,575,750</td>
<td>$ 2,603,033</td>
<td>$ 2,732,613</td>
<td>$ 2,814,593</td>
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<tr>
<td><strong>Total Fund I Cash Flow</strong></td>
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<td>$ (7,950,000)</td>
<td>$ (6,641,647)</td>
<td>$ 9,275,591</td>
<td>$ 9,535,863</td>
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<td>$ 4,840,062</td>
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</tr>
<tr>
<td>Acquisition Cost</td>
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