Point of View

Overpayment of Manager Incentive Fees—When Preferred Returns and IRR Hurdles Differ

Executive Summary. *An evolution has taken place in terms of manager incentive fee documentation. Originally, incentive fees were based on a "preferred return" methodology whereas, today, most contracts use an IRR hurdle methodology. Although this change generally has been treated as a non-event, the change has generated unanticipated consequences that can be quite significant.*

In instances where additional equity capital is called after an earlier split of profits, the equivalence of these two formulations fails. Further, even when such is not the case, if the investment is a portfolio and the contract allows for interim incentive fee payments based on only assets sold to date, the same problem can occur. For large portfolios, millions of dollars of fees can hang in the balance, amounts that will accrue to the investor or the manager based solely on the calculation methodology utilized. We believe that this phenomenon has been inadvertently embedded in many institutional real estate portfolio fee arrangements.

With the recent sharp downturn in the real estate market, rates of return have been so low as to temporarily render this issue moot. With the market beginning to recover, this is an opportune time to 'daylight' this issue.

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The Evolution of How Incentive Fees Have Been Specified

When institutional real estate deals first started including incentive fees, contracts typically specified something akin to the following: First, the investor gets a 10% preferred return on any unreturned capital and second, gets its capital returned,[1] and then, of the remaining "promotable proceeds," the investor gets a 70% share (as "excess investor profits") with the real estate manager getting a 30% share (as the "promote"[2]). This will be referred to as a Preferred Return Formulation.

For many years, language along the lines of the Preferred Return Formulation was the norm. However, with the advent of cheap and powerful computing capability, over time, the earlier formulation often morphed into a seemingly equivalent "IRR Hurdle Formulation" that reads something akin to the following: First, the investor gets a 10% IRR and then, of the promotable proceeds in excess of the IRR hurdle, the investor gets a 70% share (as excess investor profits) with the real estate manager getting a 30% share (as promote).

The question is: Is there any real difference between these two formulations? The vast majority of practitioners that we've surveyed in the real estate industry believe the answer is no. And, for the majority of portfolios, this is the correct answer.

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But there are several, non-trivial situations in which these two seemingly synonymous formulations yield different results—sometimes dramatically so. And depending on whether one is the investor or the manager, one formulation or the other can be more beneficial. As will be shown, in those cases where there is a difference, the Preferred Return Formulation favors the investor, whereas the IRR Hurdle Formulation favors the manager.[3]

Generally, differences between the two formulations arise in investment portfolios when new equity capital is called late. We define "late" to mean nothing more than that capital is being contributed by the investor after some promotable proceeds have already been split between the investor and the manager. Admittedly, for a single real estate asset, such scenarios are infrequent, the most obvious one being when some additional equity infusion becomes necessary after a very profitable (i.e., hurdle-exceeding) cash-out refinancing has occurred.[4] However, when the incentive fee arrangement is to be applied to a *portfolio* of real estate assets, as is often the case in the world of institutional real estate investment, the likelihood of a discrepancy increases substantially.

Example 1

For purposes of illustration, it's best to start with a simple example, one with only four equity cashflows. In the first year, $100 million is contributed; in the second year, $150 million is distributed; in the third year, $25 million is contributed; and in the fourth year, $35 million is distributed, as detailed below.

Year One	−$100 million
Year Two	$150 million
Year Three	−$25 million
Year Four	$35 million

This example is intended to represent a portfolio where the Year Two distribution is promotable and a 'late' contribution is made in Year Three. The requisite incentive fee computations are detailed in Exhibit 1. For ease of following the math, note that most line item labels include a description of how they are computed, e.g., for line item C, it ends with "= A – B."

First, consider the Preferred Return Formulation, as delineated on the left-hand side of Exhibit 1. For either the Year 2 or Year 4 distribution, and also for the overall sum, the investor gets exactly 70% of the promotable proceeds (line items G, N, and Q). We contend that this is precisely what one should expect with a promote of 30%. As a consequence, 76.3% of the "whole dollar profit"[5] (line item T) gets paid to the investor, which includes the $12.5 million of preferred return (sum of line items D and K) plus the investor's $33.3 million share (line item Q) of the $47.5 million in promotable proceeds above the preferred return hurdle.

Implicit in the Preferred Return Formulation is that, any time additional equity capital is invested, it must be later paid back, along with whatever preferred return accrues to it while it is outstanding (i.e., before any *additional* proceeds become 'promotable'). In other words, regardless of how well the portfolio might have performed in the past, the return of new capital (and the preferred return on new capital) must occur before the manager can *once again* participate in distributions. This assures that the funds paid to the manager will always be exactly equal to the intended 30% of distribution amounts in excess of the amounts necessary, from time to time, to meet the targeted return on each invested dollar.

Next, consider the IRR Hurdle Formulation, as delineated on the right-hand side of Exhibit 1. The Year 2 distributions are exactly the same as outlined above using the Preferred Return Formulation. However, before distributing any Year 4 cash, the investor already has achieved an IRR of 16.5%,[6] even after including the Year 3 contribution of $25 million. Since the investor's IRR is already in excess of the 10% IRR hurdle, the entire $35 million to be distributed in Year 4 will be promoted (i.e., split 70%/30%).

In order to compare the results of the two formulations, reference is made to line item P, both on the left- and right-hand sides of Exhibit 1. As compared to the $14.3 million that the manager receives in the Preferred Return Formulation, the manager receives $22.5 million in the IRR Hurdle Formulation, or an additional $8.2 million. And, of

Exhibit 1

Comparison of Profit Splits (all dollars in millions)

ANNUAL CASH FLOW	
Year One	($100.0)
Year Two	$150.0
Year Three	($25.0)
Year Four	$35.0
Whole Dollar Profits: $60.0	
Investment Level IRR: 49.0%	

Preferred Return Formulation				IRR Hurdle Formulation			
Year Two Distributions				**Year Two Distributions**			
A. Proceeds Available	$150.0			A. Proceeds Available	$150.0		
B. Return of Capital	$100.0			B. Return of Capital	NA		
C. Proceeds Remaining = A − B	$50.0			C. Proceeds Remaining = A − B	$150.0		
D. Preferred Return @ 10%	$10.0			D. Amount Needed To Reach IRR Hurdle (1)	$110.0		
E. Promotable Proceeds For Splitting = C − D	$40.0			E. Promotable Proceeds For Splitting = C − D	$40.0		
F. Manager Promote @ 30%	$12.0	30.0%		F. Manager Promote @ 30%	$12.0	30.0%	
G. Excess Profit To Investor = E − F	$28.0	70.0%		G. Excess Profit To Investor = E − F	$28.0	70.0%	
Year Four Distributions				**Year Four Distributions**			
H. Proceeds Available	$35.0			H. Proceeds Available	$35.0		
I. Return of Capital	$25.0			I. Return of Capital	NA		
J. Proceeds Remaining = H − I	$10.0			J. Proceeds Remaining = H − I	$35.0		
K. Preferred Return	$2.5			K. Amounts Needed To Reach IRR Hurdle (2)	$0.0		
L. Promotable Proceeds For Splitting = J − K	$7.5			L. Promotable Proceeds For Splitting = J − K	$35.0		
M. Manager Promote @ 30%	$2.3	30.0%		M. Manager Promote @ 30%	$10.5	30.0%	
N. Excess Profit To Investor = L − M	$5.3	70.0%		N. Excess Profit To Investor = L − M (3)	$24.5	70.0%	
O. Total Proceeds for Splitting = E + L	$47.5			O. Total Proceeds for Splitting	NA		
P. Total Promote to Manager = F + M	$14.3	30.0%		P. Total Promote to Manager = F + M	$22.5	47.4%	(4)
Q. Total Excess Profit To Investor = G + N	$33.3	70.0%		Q. Total Excess Profit To Investor	NA		
R. Total Distributions to Investor = B + D + G + I + K + N	$170.8			R. Total Distributions to Investor = B + D + G + I + K + N	$162.5		
S. Capital Advanced	$125.0			S. Capital Advanced	$125.0		
T. Whole dollar profit to Investor = R − S	$45.8	76.3%	(5)	T. Whole dollar profit to Investor = R − S	$37.5	62.5%	(5)
U. IRR to Investor	37.2%			U. IRR to Investor	33.1%		

Notes:
(1) Although IRR does not discriminate between return of capital versus return on capital (preferred return), the hurdle amount equals the sum of the two, shown at the left.
(2) The IRR to the investor is already over the 10% hurdle at 16.5%, so all Year Four distributions are promoted.
(3) On the right-hand side, this is excess profit compared to zero, since no IRR Hurdle amounts need to be paid from this Year Four distribution.
(4) Expressed as a percentage of the $47.5 million "Total Proceeds for Splitting" of Item O, of the Preferred Return Formulation to the left.
(5) This is Item T, expressed as a percentage of the sum of Items P and T (i.e., the overall portfolio whole dollar profit), which is 60 million dollars.

course, that means the investor receives $8.2 million less. In other words, this $8.2 million ends up either in the pocket of the manager or the investor depending on whether the Preferred Return Formulation or the IRR Hurdle Formulation was written into the deal documentation. Line item P also addresses the discrepancy in percentage terms. Using the $47.5 million promotable proceeds of the Preferred Return Formulation as the relevant denominator, the manager (investor) receives about 47.4% (52.6%) of such amounts with the IRR Hurdle Formulation, respectively. This is to be compared to the 30% (70%) that the manager (investor) would receive with a Preferred Return Formulation, respectively. Alternatively measured, via line item T of Exhibit 1, the investor receives only 62.5% of the whole dollar profit with the IRR Hurdle Formulation as compared to 76.3% with the Preferred Return Formulation. The difference in IRR to the investor, as shown on line item U of Exhibit 1 is 4.1%, or the difference between 37.2% for the Preferred Return Formulation and 33.1% for the IRR Hurdle Formulation. The difference is striking, both in dollars and in IRR.

This phenomenon occurs because, with the mechanics of IRR, cashflows are, in essence, fungible. In the IRR Hurdle Formulation, the prior period excess profits paid to the investor in Year 2 are algebraically "reclassified" to cover the Year 3 equity capital outlays, as well as their accrued preferred return over the one year it remained outstanding.[7] In essence, the investor sees some or all of its Year 2 excess investor profit reclassified into return of capital and return on capital, as contrasted with the manager's portion that remains untouched. The intended split of 70%/30% of the Year 2 distribution amount has been compromised, retroactively. An additional compromise will occur each time there is a subsequent equity contribution, until all prior excess profits of the investor have been exhausted.[8] This phenomenon associated with an IRR Hurdle Formulation (i.e., where there is reclassification of the excess profits of the investor) will be hereinafter referred to as simply "reclassified profits."

When Can Reclassified Profits Occur?

Here are four common scenarios where there can be reclassified profits.

Asset or Portfolio Context

1. There is a large cash-out refinance of an investment which, subsequently, has a need for a further equity capital infusion.[9]
2. The incentive fee agreement allows for sharing of *operating* cashflow when it exceeds a certain preferred return.[10]

Portfolio Context Only

3. This is a fund-oriented equivalent of scenario 1 above, wherein early assets are so profitable so as generate incentive fees prior to all equity being called. For example,
   a. There is a fund with a, say, three-year investment period and one or more of the early investments is sold at a handsome profit, which results in a split of promotable proceeds, sometime prior to the end of the third year. At the end of the third year, a final equity contribution is made.
   b. The fund above is an opportunity fund and it invests in a development asset that begins in year three, but still requires capital to be contributed for another 18 months after the development begins.[11] It is possible that such a fund might have one or more other investments sold very profitably before the final equity contribution is made for the last development asset.
4. There is an interim promote structure in place that uses what we call a "rolling realized portfolio." This means that, each time an asset is sold, the manager's (cumulative) promote amount earned is re-computed based on only the contributions (and distributions) associated with the sub-portfolio of assets that have already been sold.[12] This is a common structure that purports to be a 'faster converging' version of another common structure that simply pays interim promotes to the manager based on the performance of each asset in isolation, as it sells, with some sort of portfolio-based 'true-up' at the end.

As footnoted earlier, Scenario 1 is less likely to occur if the subsequent cost is predictable since, most likely, the contract would spell out the fact that the parties have agreed that some portion of the refinanced proceeds must be placed in reserve to cover that upcoming cost.

Although the amounts are probably smaller, Scenario 2 occurs from time to time, as the promoting of operating cashflows is a deal feature that is sometimes seen, whether for an individual asset or a portfolio deal. The investor's share of all excess operating cashflow gets reclassified as return of capital upon sale, thereby allowing more of the sales proceeds to be promoted and, retroactively, compromising the intended split of excess operating cashflow.[13]

Scenario 3 requires somewhat atypical circumstances, such as early sales of highly profitable assets, which yield distributions that are sufficient to also 'cover' the contributions and preferred return of the assets still unsold. The likelihood of such is very low early on, although it increases gradually as more and more assets in the portfolio are sold. Nevertheless, considering that there are a large number of funds and joint ventures in place, we speculate that there are some serious incentive fee amounts potentially in dispute as a result of this phenomenon.

Nevertheless, we believe it is Scenario 4 that, by far, represents the most misunderstood, if not also the most important (in terms of the sheer amount of money at risk) source of reclassified profit problems that we see played out in the present-day world of institutional real estate investment. The mechanism by which this occurs is by no means obvious and is best illustrated by ever-so-slightly revising Example 1.

Example 2: Extension to the Case of Interim Promotes

The example associated with Exhibit 1 assumed an investment that paid an early promote simply because it had already been earned, based on the equity cashflows to date. Specifically, the first distribution was sufficient to cover all prior contributions and accrued preferred return to date or, equivalently stated, it was sufficient to meet the IRR hurdle. Example 2 has two distinct assets,[14] assets whose proceeds are subject to interim promote payments based on the aforementioned 'rolling realized portfolio' of sold assets. However, in order to underscore the point that the second asset need *not* be acquired after the first asset is sold, assume that the second asset is acquired in the *same* period in which asset 1 sells. This second asset is still assumed to be held one year, and so now it sells in year three, at which point the portfolio becomes completely liquidated. The revised cashflows are as follows:

Asset 1		*Asset 2*	
Year One	−$100 million		
Year Two	$150 million	Year Two	−$25 million
		Year Three	$35 million

Clearly, the asset 1 distribution of $150 million will be treated the same as in Exhibit 1, since the existence of Asset 2 has not been recognized yet, even though its equity contribution has, indeed, already been made. In Year Three, asset 2 sells and the question is: What should happen to its $35 million of proceeds?

There are two common contractual approaches. The first approach follows a Preferred Return Formulation where the distribution from a new, well-performing asset's sale must 'cover' any shortfalls of unreturned capital or preferred return associated with prior sales of poorly performing assets. Hence, in addition to paying back its own unreturned capital and preferred return, it must also cover prior sold assets' shortfalls (i.e., before any remaining proceeds can become promotable). However, to the extent that an asset produces excess profits for the investor, there is no mechanism for carrying that excess forward to cover the shortfalls of future poorly-performing assets.[15]

The second approach follows an IRR Hurdle Formulation that tests whether the investor's IRR to date has met the hurdle. To the extent that the IRR hurdle, prior to considering the distribution in question, has already been met, or will be met using only some of the to-be-distributed amount in question, the remainder will become promotable proceeds subject to splitting. Implicit in this formulation is that the IRR to date, due to its aforementioned fungibility of all dollars, includes all prior distributions to the investor. This produces the equivalent of Example 1's reclassified profits phenomenon.

Since the example only has two assets, we can easily focus on the differences in how this portfolio would end.

1. If a Preferred Return Formulation is used, the distribution amounts of our example will be exactly the same as they were on the left-hand side of Exhibit 1. Note that the investment in each asset exceeded its hurdle.
2. If an IRR Hurdle Formulation is used, the splits will be exactly the same as on the right-hand side of Exhibit 1, assuming the investor's hurdle has already been passed, which is the case here (IRR = 13%),[16] even after including the asset 2 equity contribution. That is, all asset 2's to-be-distributed amounts will be subject to being promoted.

Hence, we have shown that the same discrepancy between a Preferred Return and IRR Hurdle Formulation can arise *even when all capital contributions occur early* (i.e., if we have an interim promote structure that 'counts' an asset's capital contributions only after the asset has sold). This is what one might call a 'de facto late contribution.'

This article has only addressed an example where all investments have been successful. If the portfolio ends badly, the investor may need other protections, such as reserve accounts and clawbacks, something that is out-of-scope here, but which is thoroughly addressed in Carey (2006).

Conclusion

For many single asset investments, as well as many portfolios, promotes to the manager (and excess profits to the investor) will not be generated until sometime after all equity has been invested. In those cases, the Preferred Return Formulation and the IRR Hurdle Formulation will generate identical results.

In some cashflow scenarios, there is a marked difference between the incentive fee results of these two formulations, due to reclassified profits. In Carey (2006), the real estate attorney first described this phenomenon using an example of an asset that had a large cash-out refinancing, followed by the need for an equity infusion in an asset that later turned out to be nearly worthless.

We hope we have added the following to the body of knowledge:

1. The reclassified profits phenomenon is not limited to scenarios where investments end badly. In fact, it can be shown that the impact is 'worst-cased' when the asset, or every asset in the portfolio in question, performs well.
2. The phenomenon can also occur if there are incentive fees earned separately on operating cashflow (i.e., if the investor's share of that excess cashflow is counted toward the eventual achievement of an overall IRR hurdle).
3. The evolution in incentive fees, wherein IRR hurdles replaced preferred returns, was misguided, in our opinion, because reclassification of profits is unfair, in particular to the investor. Most likely, the initial switch to IRR was well-intentioned, and the idea was advanced as a simpler alternative that was thought to be equivalent.
4. The reclassified profits phenomenon is far more likely to go unnoticed in portfolios of assets, rather than with individual assets and the biggest reason for this, by far, is due to the proliferation of interim promote schemes used in institutional real estate investment vehicles. This conclusion follows our recent discovery that the calculus behind many of these interim promote schemes inadvertently generates *de facto late contributions*.

So, to the negotiating principals responsible for the investment deal documentation, we note that it is important to focus on the difference between a Preferred Return Formulation and an IRR Hurdle Formulation. This is particularly true if there is reason to believe that the investment might require at least one equity contribution from investors after the time when the first promote payment to the manager might occur.

And, to the computer programmer/analyst, it is important to *not* simply take the easy way out and model the deal with an IRR Hurdle Formulation when the contract calls for a Preferred Return Formulation, all-the-while assuming they are mathematically equivalent.

It is our belief that most institutional investors expect that they are getting the results from a Preferred Return Formulation irrespective of which formulation is actually in the deal documentation.[17] Assuming that such (i.e., the intended, say

70%/30% split of proceeds above return of capital and its preferred return) is the intent of a waterfall deal, what are the choices?

One solution is simply to use a Preferred Return Formulation, since this formulation does not reclassify the investor's early excess profits to cover either later return of capital or its later 'interest.' Neither does it reclassify early higher tier dollars into later lower tier dollars (i.e., in the case of multiple hurdles and their multiple promote tiers). All return hurdles will reflect a preferred return of sorts, first the primary one, then the secondary one, and so on, depending on how many rate of return breakpoints have been negotiated into a particular deal's profit sharing structure.

Alternatively, a second solution is to let the deal documentation retain the highly popular IRR Hurdle Formulation, but to ensure that it explicitly defines which cashflows are to be counted. Specifically, for purposes of computing how much additional cash is necessary for the investor to meet an IRR hurdle, often referred to as the "IRR deficiency," the only prior distributions to be counted are those made towards the IRR hurdle in question.[18] This will prohibit the counting of any "excess investor profit" distributions received in prior periods and, thereby, prevent any reclassification. Naturally, the person responsible for programming this waterfall structure needs to take special care to layer this stratification of cashflows into the usual, plain-vanilla, IRR-based waterfall analysis.[19]

The Appendix addresses a related phenomenon that has perplexed two sets of investor and manager partners recently. We believe that this sort of phenomenon is happening frequently in the world of institutional real estate investment, as well as, possibly, in the private equity arena where such 'waterfall structures' are also commonly used; and that it is being routinely misunderstood.

Appendix

Two Related Occurrences with Interim Incentive Fee Payments

The analysis below is drawn from two recent multi-million dollar disagreements between plan sponsors and real estate managers.

All else equal, it is generally believed that a portfolio-based, interim promote approach will never be worse for the investor than an approach that allows promotes to be earned on an asset-by-asset basis. The rationale for this is clear: With an asset-based promote approach, there is a lack of symmetry, in that the manager earns an incentive fee on every well-performing asset, but is not penalized for poorly-performing assets. Further, if the incentive fee agreement has multiple hurdles (and associated increasing promote percentages), the manager may participate to an even higher degree in the best performing assets while, once again, giving nothing back for the lesser performing assets.

Alternatively, with a portfolio-based promote, the performance of the portfolio is what drives the incentive fee and, to the extent there are poorly-performing assets, the resultant incentive fee amounts should be smaller.

Occurrence 1

This disagreement involved a portfolio that called for asset-based promotes. After about 75% of the assets had been sold, the manager made a projection of his total incentive fees assuming a constructive sale of the remaining assets. Out of curiosity, the manager also computed how much lower his fee would have been if the contract had called for a portfolio-based promote. Much to his surprise, he concluded that such a portfolio-based promote would have rewarded him with a considerably higher, rather than lower, incentive fee as compared to what he was slated to receive with the asset-based promote approach in place.

In this case, the manager assumed a rolling realized portfolio approach, and used an IRR hurdle Formulation which, as has been shown herein, reclassifies the investor's early distributions of excess investor profits. Because so many of the early assets performed well, the IRR Hurdle Formulation produced several million dollars of "reclassified profit," thereby producing a very inflated incentive fee.

Compare this to the asset-based promote structure already in place. For all its faults of asymmetry

(from the investor's perspective, as noted four paragraphs above), an asset-based promote approach does not reclassify profits. Specifically, in an asset-based promote approach, each asset's distribution must pay back its own unreturned capital and cover its own preferred return (or, equivalently, meet its own IRR hurdle), in order to produce promotable dollars.

Because of the specific calculation methodology employed by this manager, and the fact that the portfolio had many well-performing assets, especially early on, and very few badly performing assets at all, the investor would have been better off with an asset-based promote structure than a portfolio based structure. However, if the manager had used a Preferred Return Formulation, the portfolio-based fee would have been much lower and this counterintuitive result would not have occurred.

Occurrence 2

This involved a structure that also used asset-based promotes, but included a portfolio-based 'true up,' to be implemented after the final asset sale. The concept behind a portfolio-based true up is that it will limit the amount of fees produced by asset-based promotes in cases where some of the assets perform poorly, That is, it would effect a downward adjustment to correct for the aforementioned asymmetry feature. However, as it turned out, the manager's true up calculation produced the counter-intuitive result that he should receive an even higher fee. The details of the portfolio true up are not important, other than to note that it did not address how the true up should be computed. The manager used an IRR Hurdle Formulation. Not surprisingly, a Preferred Return Formulation was tested by the consultant and it produced an incentive fee that was lower, rather than higher, than the asset-based fees. The issue is in the process of being resolved.

Endnotes

1. The order of the preferred return versus return of capital payments assumed here follows what is used for most variable payment mortgage loans, where interest is always paid first and any excess is applied toward reducing principal. However, the order could just as easily be reversed with no impact whatsoever, since a dollar of unreturned capital accrues the same amount of additional preferred return as does a dollar of unpaid, but already accrued, preferred return. Indeed, in an IRR Hurdle Formulation, the distinction between return *of* capital and return *on* capital does not exist.
2. For the simple, illustrative, incentive fee structures used, the only component of the "incentive fee" will be the "promote" amounts. Hence, we will often use the term "promote" as shorthand for the more general "incentive fee" terminology.
3. The terms "manager" and "investor" are used here, but they could just as easily be replaced with "local operator" and "sponsor", or "GP" and "LP," respectively.
4. As noted in Carey (2006), to the extent that the future capital infusion is foreseen, the partners could agree to simply withhold sales proceeds in sufficient amounts so as to cover it. This would eliminate the need for an equity call and avoid the problem altogether.
5. This is simply the sum of all distributions less the sum of all contributions (i.e., \$185 − \$125 = \$60 million).
6. This computation is not shown, but can easily be calculated from the first three cashflows of the investor of −\$100, +\$138, and −\$25. The \$138 reflects the fact that, from the first distribution of \$150, the investor gets everything except the \$12 promote payment.
7. Conceptually, these two formulations are representative of the two most frequent, and different, programming approaches we most often see. Since most incentive fee analyses are programmed in Excel, endless variations on these themes (e.g., hybrids) are possible.
8. Also, it is noted that each time there are distributions sufficient enough to, once again, cross the IRR hurdle, a new supply of excess investor profits becomes available for potential future reclassification.
9. This is the scenario assumed in the referenced article, which was published in 2006 and referred to "recycled profits" rather than our terminology of "reclassified profits." In private deals, the investor may convince the manager to agree to a "reverse waterfall" wherein subsequent contributions are 'funded' by both parties, in proportion to the marginal split of prior promoted proceeds (until they are exhausted), which circumvents this Scenario 1 problem altogether.
10. More often than not, contracts are inadvertently, we believe, worded such that the investor's share is applied to the overall IRR waterfall including capital events, thereby allowing this share of excess operating cashflow to be *reclassified* as return of capital.
11. Most partnership agreements allow for additional capital calls after the investment period ends, as long as the asset has been purchased, or even merely contracted, prior to the end of that period.
12. For sake of simplicity, we will not address the details of how prior promote payments might be adjusted prior to subtraction, from the new cumulative promote, which is, generally, a current-year dollar quantity.

13. Because there is no such thing as preferred return with an IRR Hurdle Formulation, reclassification in this scenario cannot happen as inadvertently/innocently as it does for the other scenarios. The algebra will need to use a Preferred Return Formulation, but one that is altered by the programmer so as to purposefully apply the investor's share of excess operating cashflow toward the unreturned capital balance.
14. From two assets, one can extend to as many assets as one cares to, without loss of generality. It's best to think of asset 1 as the realized portfolio to date, with asset 2 being the remainder of the portfolio yet to be realized. As more assets are realized, the likelihood of creating reclassified profits within an IRR Hurdle Formulation grows.
15. Nor, by analogy to Example 1, do we think there should be.
16. This computation is not shown, but can easily be calculated by using the cashflows to the investor to date of −$100, +$113. The $113 reflects the fact that, from the first distribution of $150, the investor gets everything except the $12 promote, for a total of $138, but has a same-period equity capital contribution of $25.
17. To the extent that current period contributions are netted against current period distributions, we would argue that an implied Preferred Return Formulation has already been introduced, at least to a limited degree.
18. This second solution needs a bit of clarification with regard to multiple-hurdle IRR waterfalls. In computing the amounts necessary to achieve each hurdle, one needs to include all prior and current payments to all lower hurdles, as well as all prior payments to the hurdle in question itself, but one needs to exclude all prior payments toward higher hurdles. Also, keep in mind that, if there are late contributions, the rate of return can exceed a hurdle at some point in time, but later drop below it again.
19. To be clear, we are *not* advocating against the use of IRR in general, a metric which is almost universally embraced as the easiest method for computing the ultimate money-weighted rate of return earned by the investor. We are merely suggesting that incentive fee hurdles, if they are to be based on IRR, need to apply the IRR measure to certain stratified cashflow streams.

Reference

Carey, S.A. Real Estate JV Promote Calculations: Recycling Profits. *Real Estate Finance Journal*, 2006, 22:1, 5–20.