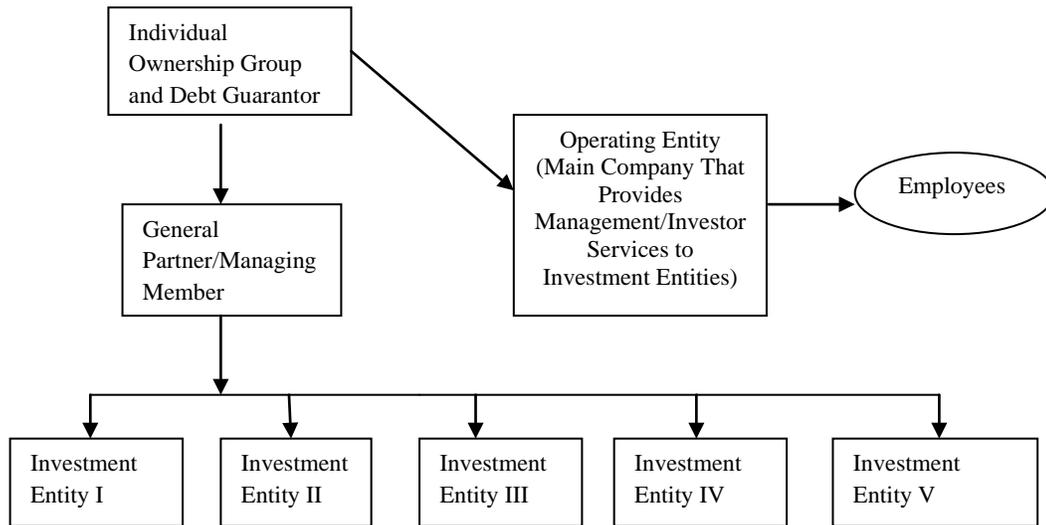


CREATING ENTERPRISE VALUE IN COMMERCIAL REAL ESTATE ORGANIZATIONS

In today's tumultuous commercial real estate industry, everyone is seeking an edge or opportunity to buy assets at attractive cap rates or create value in existing assets. In one of my prior articles, I discussed how to create commercial real estate Alpha through various property level and market based strategies. In this article, I will discuss how to create Enterprise Value in private real estate organizations. In corporate finance, Enterprise Value is defined as the market value of the common equity plus the market value of the company's debt less the amount of cash and cash equivalents. For this article, real estate Enterprise Value is defined as the owner's net equity value in the real estate assets plus the imputed goodwill or market value attributed to the real estate operating organization. The market value of the real estate operating organization is derived from its reputation, property and asset management skill, financing prowess, development expertise and growth potential.

Many real estate companies are astute at creating value in their real estate assets but often overlook the value in their company's organizational structure. Most entrepreneurial real estate investment organizations whether a developer, private equity fund or asset manager are structured with a main or operating company (Operating Entity) that includes most of the employees, provides accounting and management service and is the face of the organization. Each real estate investment in these organizations is usually housed in various bankruptcy remote affiliated limited partnerships or limited liability companies (Investment Entities) as separate entities. Entities controlled by the ownership group are usually the general partner or managing member of these Investment Entities and own the carried interest. These entities have different equity investor groups that provided all or a large portion of the equity investment along with various third party debt financing. The Operating Entity or an affiliate usually provides asset or property management services and acts as the investor relations department for the Investment Entities. I've seen many organizations with this structure and some with more than thirty affiliated Investment Entities. This organization structure is very unwieldy and can be difficult to manage. A typical organization chart for this company structure is shown below.

TYPICAL REAL ESTATE OWNERSHIP ORGRANIZATION CHART

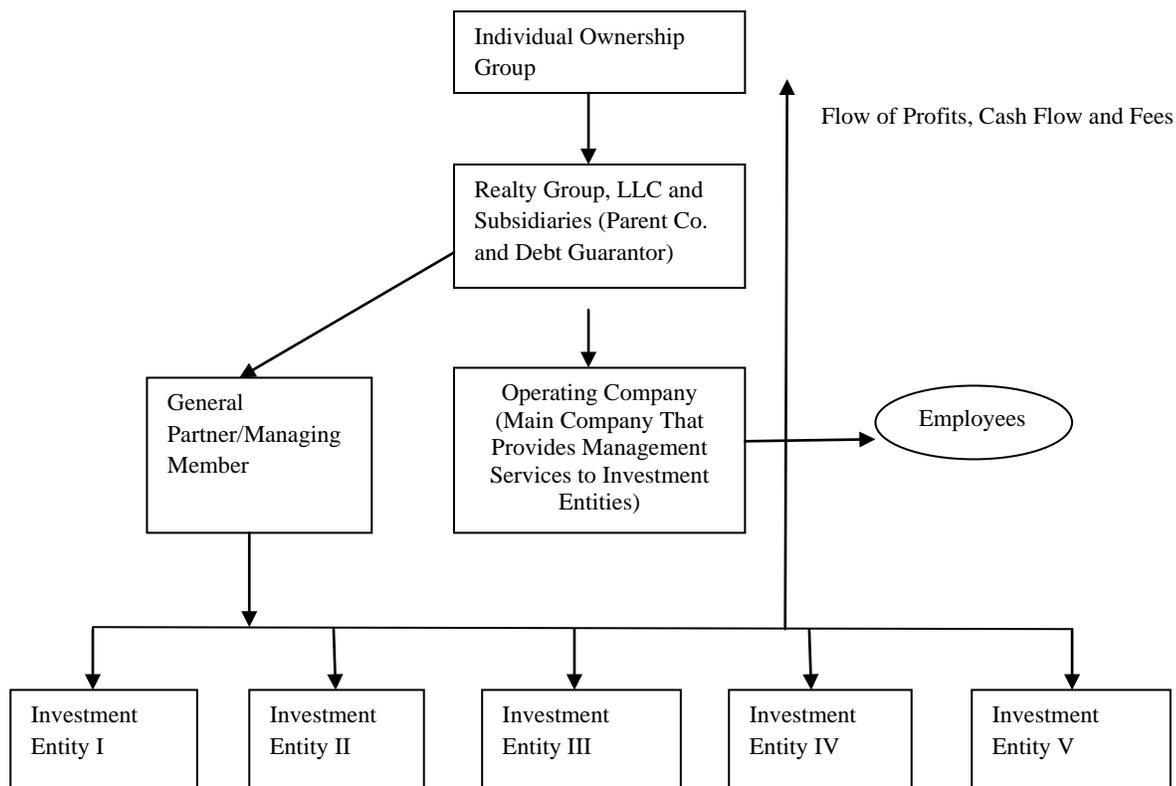


Although, this structure is very common, it has two serious drawbacks. First, is when the organization is required to provide company financial statements to a lender or potential investor. The organization usually provides the personal financial statements of the managing partner(s) ownership group because the revenue, cash flow and net worth of the Operating Entity are insignificant. Individuals that own the ownership group then become the guarantors of any credit lines, construction loans or other debt sought for the Investment Entities and therefore incurs substantial contingent liabilities. I have seen a number of development organizations with this structure, wherein, the managing partner had millions of dollars in loan guarantees for each real estate deal. Second, is that this type of organization structure is cumbersome and most importantly, does not generate any real estate Enterprise Value. The value of the ownership group's carried interest in the Investment Entities flows up to the individual owners and does not flow up or accrue to a parent company of the entire organization. The value of the Operating Entity is typically minimal and the only value it derives is from property and asset management fees and other services provided to the Investment Entities. If the whole organization is put up for sale, the only value is the ownership group's carried interest in each Investment Entity and there is virtually no value credited to the Operating Entity, management and goodwill or Enterprise Value.

A better structure and one that creates this Enterprise Value is to have at the top of the organization structure, a parent entity that will be called, Realty Group, LLC. This entity will be the primary operating company and debt guarantor for the organization. A subsidiary LLC or partnership of Realty Group, LLC, will be the general partner or managing member of each

Investment Entity with all fees and carried interest flowing up to the parent company, Realty Group, LLC. Each Investment Entity will also be consolidated into Realty Group, LLC for financial statement purposes so that there is one set of consolidated financial statements for the entire organization (this will depend on the accounting for Variable Interest Entities, which is beyond the scope of this article). The consolidated financial statements would be for Realty Group, LLC and Subsidiaries. The ownership group will then hold its controlling interest in the parent company, Realty Group, LLC, instead of at the Investment Entity level. They may sell or leverage their equity interests in Realty Group, LLC as permitted by partner or operating agreements. This structure will create a single parent company with consolidated financial statements to be presented to banks and lenders for financing and guarantees and removes the individuals from any guarantee risk. This structure also allows for all cash flow, profits and fees to flow up to the parent company to increase cash flow, economic value and create Enterprise Value for Realty Group, LLC and its owners. The ownership group, which will now own shares in Realty Group, LLC, should realize substantially higher Enterprise Value for its interests than under the old structure.

ORGANIZATION CHART THAT CREATES ENTERPRISE VALUE



Most entrepreneurial real estate investment and development organizations are structured with an operating company and numerous bankruptcy remote special purposes entities that each own real estate assets. This structure does not create Enterprise Value for the entire organization and the only equity value is the ownership interests in each Investment Entity. Real estate companies can create Enterprise Value by restructuring their organization into one with a parent company that owns the Operating Company, provides any guarantees and has affiliates that own the carried interests in the real estate Investment Entities. This organizational structure will allow for consolidated financial statements at the parent level and create for the organization, Enterprise Value, above and beyond the value of their carried interests in the real estate Investment Entities.

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