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Structuring a CRE Equity Compensation Program

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Joseph Ori, executive managing director of Paramount Capital Corp.

Compensation for CRE professionals is varied depending on the position but typically include a salary, bonus and commission formula. So says **Joseph Ori**, executive managing director of **Paramount Capital Corp.**, in this exclusive commentary. “Professionals on the deal side of the industry which includes sales, leasing and financing brokers are on 100% commission with maybe a draw against the commission,” he says. “Compensation for REIT professionals includes a base salary, bonus and some type of equity incentive including stock options or restricted stock units. Compensation for real estate private equity firms usually includes a base salary, bonus and equity incentive.”

The views expressed in the commentary below are the author’s own.

The equity incentive can be an ownership interest in investments made by the firm, a portion of the sponsor’s carried interest or company profit sharing. It is very important to compensate properly employees in the CRE industry as they are the knowledge capital providers of the firm and critical to the success of the organization.

The most important asset in a CRE company or any company for that matter, are not its assets, leases, capital providers, size or investment returns, but its people. We are in a society and business environment that is based on knowledge capital that derives from a company's employees. The most successful companies are loaded with smart, hardworking, innovative and out-of-the-box thinking employees. CRE is no different and to create a successful compensation program, especially for the senior level employees in a private equity firm, it is important that the program allows employees to participate in the equity value of the firm's investments. This is easier said than done and many private CRE equity firms either do not have attractive equity compensation programs or poorly constructed ones. If CRE firms do not properly compensate their people, the star employees will leave the firm and in most cases become competitors to the company they left behind.

A CRE private equity firm typically raises capital from institutional investors in a special account or commingled fund format. The sponsoring firm will usually be required to invest 5%-10% of the equity. The firm will offer the investors an annual preferred return of 6%-10% and an equity ownership of 50%-80%. With this type of structure, how does the firm establish an attractive compensation program for its employees? Our suggestion is to provide all employees even down to the administrative level with an equity interest in each deal or fund. Providing this perk to all employees will increase their job satisfaction and productivity and further cement their tenure, support, work ethic and loyalty to the company.

To structure the compensation program, we will use the following information:

- CRE private equity firm with $3 billion under management in a series of real estate limited partnership funds.
- The firm has 40 employees.
- The firm invests 5% in each fund as the sponsor equity investment.
- The firm has an ownership or carried interest in each fund of 25%.
- The firm provides asset management services for each fund for an annual fee of .5% of the equity value.

The best compensation structure for the firm and its employees is to create a separate employee limited partner entity that we will call Employee LP (ELP). ELP will have an ownership interest in all the firms CRE funds carved out from the sponsors 25% carried interest. The private equity firm will reduce its 25% carried interest to 21% (or less depending on the generosity of the owners) and ELP will obtain the 4% remaining interest. Each employee depending on seniority, job description, tenure and job performance will be given as additional compensation each year limited partner units in ELP. ELP will be a limited partner in each fund and pass through to the employee owners all of the income, loss, gain and any cash flow from the 4% carried interest. The more senior members of the firm and top producers will have a greater interest in ELP than other personnel. Over time and with the full cycle completion of each fund, significant profits should accrue to ELP and the employee owners. Employees should only be eligible for interests in ELP after one year of service and their interest in ELP should vest after three years with the firm.
