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Understanding and Teaching Private Equity Structures: Modeling Real Estate Development Joint Venture Agreements

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Abstract

Private equity investments in partnerships such as funds and joint ventures are more complex than the traditional residual interest common equity that we teach in corporate finance. Cash distribution rules between operating and investing partners incorporate proprietary returns on invested capital and equity IRR-dependent residual cash flow distributions. IRR is in turn impacted by management decisions over financial leverage and investment horizon, apart from investment performance. The economic consequences of these structures is complicated and often not well understood. Using simple models of real estate development, this paper is intended as a primer on the economics of private equity structures.

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[2] Public real estate equity (e.g., REIT stock) is popular with academics given their familiarity with securities trading and the wealth of transactions-based price data, yet historically private equity has been far more important than its public counterpart. As of year-end 2009, the total capitalization of public U.S. equity and hybrid REITs was approximately $250 billion, whereas the estimated capitalization of the NCREIF index alone, composed only of holdings of participating fiduciaries (primarily pension funds and fund managers), was nearly $240 billion.