Courting millennials

Re-evaluating private equity prix fixe menu models for compensation and culture

Building a better working world

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Methodology

EY conducted a series of interviews with approximately 15 private equity real estate fund managers to discuss their practices around compensation and corporate culture. The interviews were conducted in a two-month time frame in autumn 2017.

There was a time when it was common to walk the halls of a real estate private equity (PE) shop and hear phrases like "eat what you kill" or "Partner Annual Income Net" (PAIN). These terms were defining attributes that symbolized a firm's culture. Harsh on its face, this attitude was viewed by most partners as a badge of honor signifying the survival-of-the-fittest environment coupled with the implicit understanding of significant wealth for those who survived and thrived. Yet the combination of a financial crisis, human resources consultants, and the rise of millennials has shined a light on such primitive descriptors and ushered in a new focus on the firm's values. The discussion today is around work-life balance, integrity, giving back, diversity and feedback.

Many of the executives leading the top platforms have an appreciation for the culture of old that was foundational in building their success. But with the rise of super platinum funds with strong governance, public entities with board oversight, and middle market private fund managers, adoption of real estate PE culture 2.0 has been interpreted and applied differently.

The much-discussed, over-generalized and often-misunderstood millennial generation is today the front line of deal teams. They are the ones cranking out models and doing the research, and they are key owners in the delivery of reporting packages to investment committees. So how could millennials have such different roles in fund platforms whose primary businesses have the same service offering to their investors? As an example, some firms see millennials as two-year apprenticeship models, with most expected to leave at the end of the term. Some firms in high demand place them in a "mosh pit," with calculated attrition rates and corresponding allocation for new hires to infill the turnover. And others attempt to address the attributes of their new hires, with hopes of mitigating the disruption from turnover and the associated costs of retraining and rehiring.

So which approach to millennials is the best, and which firms have it right? The answer to both questions is "none." The high-turnover firms place too little value on management skills and, in exchange, tolerate the cost of higher than necessary turnover. The apprenticeship model is also flawed, as it erodes the flow of new talent up through the organization, hollowing out what should be dynamic middle management. And the new-age manager could better optimize the reward programs to elicit healthy turnover and provide the proper levels of compensation; no more, and no less. The art is to understand the candidates you are hiring, the schools from which you can attract the best candidates, and whether or not candidates should be MBAs. Firms then need to have a clear understanding of what they have to offer candidates in the form of compensation, résumé credibility and culture. We will address each separately and build up to an overall approach.

It always starts with compensation

Real estate PE managers need to make better use of deferred compensation plans, which should be a powerful and hugely attractive tool in their effort to attract, motivate, align and retain the very best (young) talent. Many deferred compensation structures, and particularly those of privately owned, small or mid-tier managers, need a refresh to be more widely accessible to employees, provide greater liquidity and incorporate a broader suite of recognition awards to drive better performance behavior. With good communication, an evolved deferred compensation plan should also help improve retention, allowing a manager to develop a strong and successful culture.

For decades, the allure and prestige of real estate private equity has placed it at the top of the food chain for many finance and business majors coming out of the best graduate schools. Recruits looking for employment would often interview in temples of steel and granite with executive desks that had been occupied by founders who had achieved great wealth. But an adjacent sector, tech, has firmly established itself as a vocation with equal upside, and a cachet that seems to align with the work style and aspirations of a new generation.

The defection to Silicon Valley is taking a toll on financial services in general; for example, the percentage of MBA graduates from Wharton heading into the financial services industry dropped from 44% in 2005 to 33% in 2017. Today's top talent is driving a harder bargain and able to compare and contrast opportunities, work-life balance and compensation. For private equity real estate, deferred compensation is an extremely valuable and attractive tool and one that should be comparable to the financial rewards on offer from any other industry.

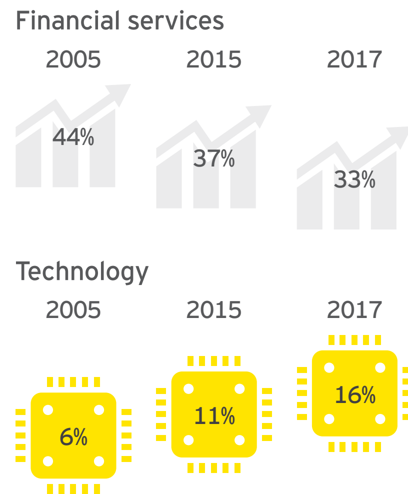
Yet for most managers, the compensation structure has not evolved as needed to attract this new talent. Given an approximate structure of 1%–2% and 20%, with profits paid once all the assets are sold, it is understandable why many compensation programs must be designed to follow the cash flow of the manager. Yet closed end funds, with contractual lives of 8–10 years, often require a great deal of patience for the big payoff. And patience is not often called out as a leading attribute of millennials.

Our research suggests that deferred compensation plans can work extremely well and remain a powerful tool for retaining employees at higher levels. Senior employees "buy into" the business and can spend a significant proportion of their careers, or their entire careers, with one employer. They are also considered to be a strong driver of alignment (at least when fund performance is strong).

82% of interviewees say the design and effectiveness of their compensation plan **provides very good alignment of individual and fund.**

36% of interviewees say the design and effectiveness of their compensation plan **strongly supports employee retention.**

Wharton MBAs — industry choices



Source: "Wharton MBAs: 2005-2017." Wharton School, Pennsylvania University, 2017.

Real estate execs on millennials

"Millennials think they are worth more than market"

"Some of the younger acquisition people think they deserve the world"

"May perceive themselves to be entitled to more"

"Want to understand how they fit and what their career looks like"

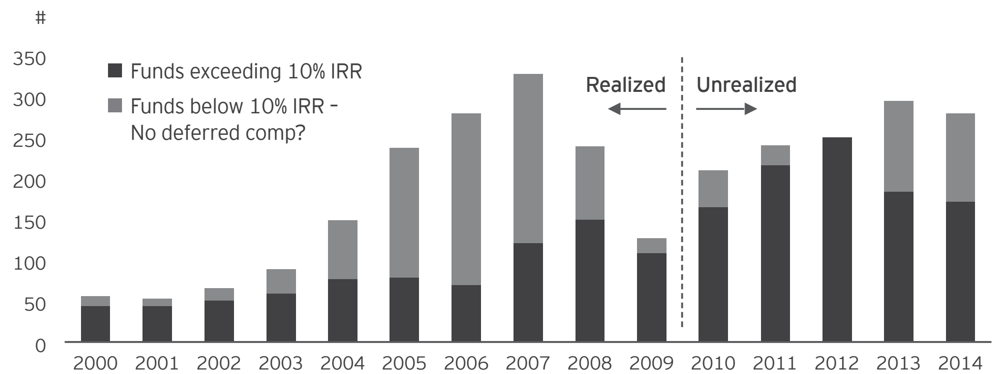
Managers are not, however, making the best use of this valuable incentive. In many organizations most employees are not included in deferred compensation plans and therefore forgo a degree of attachment or commitment to a particular manager. The structure of real estate private equity deferred compensation plans is also such that there is great uncertainty around future payments. The cyclical nature of the industry can create cliff edges; individual plans are extremely variable in terms of structure and therefore the ultimate value of the deferred compensation pot. This uncertain income will be valued differently by each employee, and the firm's culture, work environment, retention and success are dependent upon the effectiveness of the plan.

Respondents disputed where within the organization a portion of the carry should be offered, and at what level it fostered improved levels of engagement and commitment. Carry was tarnished from the financial crisis; our research suggests as many as 60%[1] of value add and opportunistic funds raised between 2004 and 2008 likely matured with little or no deferred compensation accruing to the manager and its staff. Platforms that had several difficult vintages may have employees who assign a lower value to units as the track record for payout has been spotty; conversely, newer firms or consistent top quartile firms may have a higher perceived value. The majority of senior executives associated with 2009–12 vintages, for example, are likely to soon receive exceptional windfalls — provided that market values and sales velocity hold up for a couple more years.

Figure 1: Value add and opportunistic funds by vintage

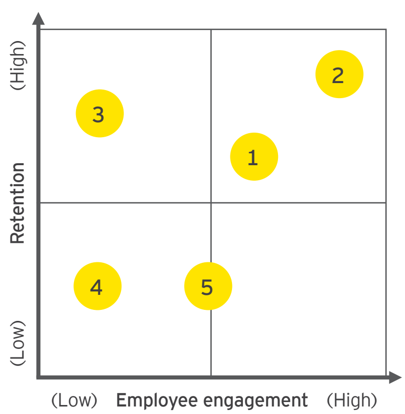
Our research suggests existing deferred compensation plans broadly fall into five categories, which are shown in Figure 2. Some of the differences in how the plans were classified have to do with the age of the platform or how the award program is administered. Certain respondents noted that too much time is invested by executives in deliberating how awards should be assigned. Others noted when decisions were made by an elite few, or one; fairness was a concern.

Value add and opportunistic funds by vintage



Source: Prequin, EY analysis

Figure 2: Private equity real estate managers — compensation maturity assessment



1	Corporate entities with refined incentive and reward programs
2	Top quartile funds that routinely deliver high compensation from carry and use it effectively throughout the organization
3	Employees with deferred benefit plans at long-standing platforms where deferred compensation drives retention, but misses on incentives that drive engagement
4	Employees at long-standing platforms on base and bonus plans
5	Organizations in this category are often startups that have not honed roles and responsibilities effectively.

Source: EY

We believe small and mid-tier, privately owned managers in particular need to reinvigorate their deferred compensation plans. There are several levers to evaluate that can be played off one another depending upon what is most important to the organization. Team continuity and the disruption of turnover can be solved through vesting, but long vesting periods need to be paired with an appropriate award level. Certain individuals will forgo carry for higher current income. More regular or frequent distribution of bonuses can improve employee satisfaction but reduce the tether that deferred compensation can offer. A well-balanced plan designed for today's work environment can be a huge incentive that helps attract, motivate, align and retain the very best young talent.

[1] EY analysis based on Preqin data. Methodology: Preqin provided IRR return data for a selection of funds across each vintage; we identified the percentage of funds exceeding a 10% return within their subset, by year, and applied the percentage to the total number of value add and opportunistic real estate funds raised in that year.

[2] Large and/or listed managers have evolved compensation structures to closely align to both the performance of their funds and the underlying business with a sufficient number of products and mix of fund/platform alignment to mitigate the worst of the challenges mentioned above.

Attributes of unit award programs

- **Who is eligible to participate in deferred comp structures?**

  Leadership, senior staff (e.g. CAO) and front office real estate staff down to VP acquisitions.

- **What percent of the manager's interest is granted to employees?**

  As low as 15% in isolated cases but 25%-40% the most common response.

- **What is the vesting period?**

  About one-third of those surveyed said more than five years. But other funds are structured around milestones (first close, final close, end investment period, life of fund) or one-third year one, one-third year three and one-third at realization. Different structures for development orientated deals or development orientated funds (milestones at acquisition, one year in and monetization).

- **Once vested, does the employee retain the units if they leave the company or is there a mechanism to buy their interest?**

  Very much depends upon what terms the employee leaves and where they go, but most plans have a mechanism to cover departure with scope to buy out unvested awards (often at a discount).

- **Does the fund distribute cash awards when earned by the manager or is a portion withheld?**

  Most distribute 100% or 100% less expenses.

- **Do you have clawback provisions?**

  Typically yes. The only exceptions were where structures are very back loaded.

- **How does your compensation plan meet the needs of tax obligations?**

  Most entities make tax distributions to address the issue of phantom income, but that is not a universal approach. In some instances, employees have to address this issue themselves. Tax distributions are likely to be subject to clawback if any.

Evolving the deferred compensation model to incentivize the private equity real estate executive of the future

Many listed private equity platforms have refined incentive and reward programs[3] to closely align to the performance of their portfolio of funds. Moreover, investor questionnaires are becoming ever more probing into matters around alignment. This encourages senior staff and other employees to focus on the underlying results of investment funds, as well as the overall performance of the firm and interests of unitholders.

Typically, cash payments to employees relating to carried interest are only made when profitable investments have been realized, and cash is distributed first to investors, then to the firm and finally to employees of the firm. Furthermore, deferred remuneration is often based on a mix of specific fund performance and the wider success of the organization. Mid-tier global funds are far more common than a decade ago. This has given rise to some debate as to how much performance fees should be aligned to regional performance, as opposed to a combination of the success of all regions and the region where the management team resides. Investors are more accepting of compensation models that resemble that of the listed firms but many privately owned small and mid-tier managers do not have the scale or breadth of product offering to directly replicate these models.

Large firms tend to enjoy cash flow from harvesting mature funds. The ebb and flow of new and legacy funds have the effect of smoothing cash flow for the manager. With only one or two funds, promotion can be far off in the horizon and uncertain. If you have a millennial on the team, these are not retention drivers. For these organizations we believe there are three overarching issues managers need to address in terms of their remuneration structure: communication, liquidity and participation. Our conversations with senior executives across the private equity real estate funds space suggest junior and mid-tier executives have a different view of carried interest than the senior executives. For the deal teams, there was usually a direct means to compute the value of the units they hold. They frequently underwrite the deals, track the performance or are in communication with asset management, such that they know how the deals are doing.

As the award program moves further away from the front office to the middle- and back-office functions, the insight into the deals that will drive promotion is muted and can have the effect of blurring the value associated with unit awards. Communication here is important, as all who participate should have a clear understanding as to what they own and its value. It is essential that senior executives communicate the value of the units. Rather than adopting an "under promise, over deliver" mantra, there needs to be clear and early messaging around the potential value of this incentive. For organizations where unit awards are decided by a single principle without a clear understanding as to how units were to be earned, communication is very important.

Bringing liquidity to deferred compensation plans is challenging. Alternative compensation models are clearly needed, and introducing some kind of incentive program with more intermittent payments has to be an improvement. For millennials, creating additional liquidity should be a priority as even if seldom used, it provides optionality and flexibility, which would be valued. This age group values experience and has life events such as housing, marriage and major purchases. Spreading bonuses throughout the year or creating liquidity from vested units will drive job satisfaction. Naturally any such scheme will need to make certain that investor-manager-employee alignment is not compromised.

Creating liquidity is difficult to achieve given the mismatch between intermittent incentives being paid to employees and manager remuneration (which will almost certainly remain back-loaded and performance-oriented). As such, this kind of incentive may be best targeted toward more mid-level staff where the sums involved are more manageable and the value of monetizing deferred rewards to enhance retention is potentially greater — after all, the existing model is reportedly working well for senior executives. Furthermore, to monetize a proportion of an unknown future reward, the individual would undoubtedly have to make a sacrifice in the form of a discount in return for liquidity. To date we have observed what we see as the one-off model, where special arrangements are made through loans, an agreement for higher current compensation for less of a deferred component, or other forms of monetization. This approach is hard to administer and time-consuming, and triggers a taxable event if under three years subject to ordinary income.

[3] See extensive compensation sections in listed manager 10Ks.

In the past, equity pools with units awarded annually and dividends accruing from deal-by-deal promotes have been used as a more regular way to award and receive benefit from deferred compensation. The industry has diverged but many well-established funds did not alter the deal-by-deal structure. Mid-market funds were pushed to pooled returns, making promote distributions further back-ended. We believe that investors in mid-market funds could find a better compromise with their investors by allowing some leakage of carry that can be distributed to the most junior participants in the plan. Key persons and the general partner (GP) would, by agreement, retain the waterfall per the overall fund performance.

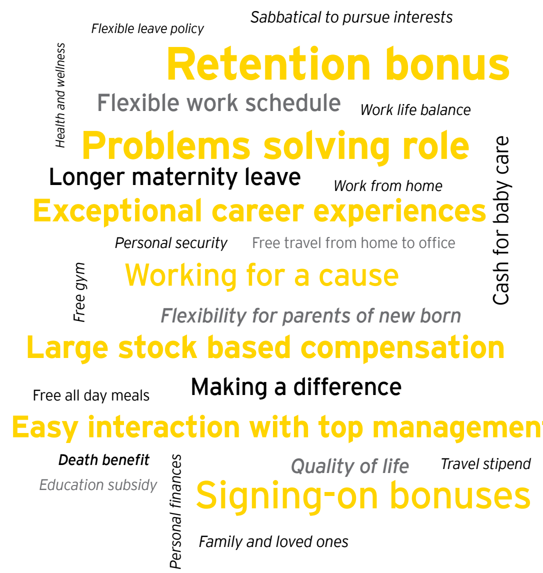
Finally, organizations need to look at widening the net for unit awards to incentivize both the broader business and the next generation of private equity real estate executives. A limitation of most GPs' deferred compensation plans is that they are less effective for non-frontline staff such as property management or back-office teams. These individuals must have access to such schemes at levels that are meaningful to each person. Organizations have a hard time translating what middle- and back-office staff do into dollar impact for the firm. Engagement and alignment benefit the entire organization, and identifying where awards drive performance and retention within the organization must be carefully considered. We would expect at a minimum the leaders of each back-office function would participate.

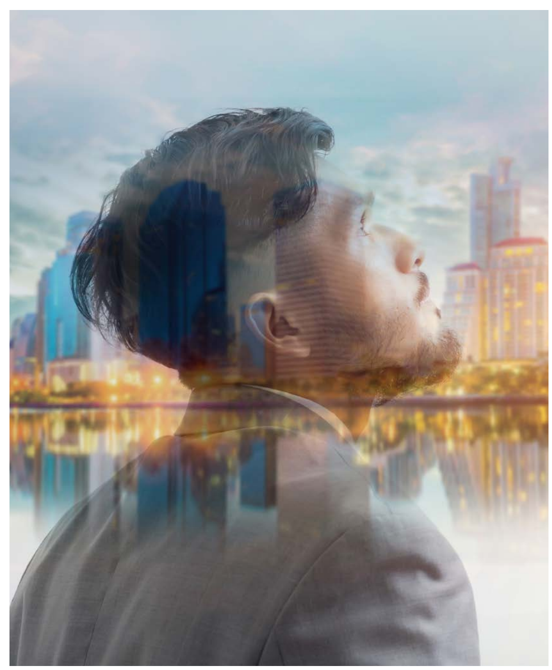
The real estate industry is also evolving as emerging trends reshape the way we use the built environment. Private equity real estate funds will need to reconsider their approach to analyzing markets and investments as technology converges with all sectors and enables new tools, analytics and insight. Technology will be a huge facilitator of better capital allocation decisions but it will also require different skills, not least the ability to build, deploy and manage bespoke tools that provide unparalleled insight into the use of specific assets and the analytics that results.

Many of these skills will overlap with the requirements of other sectors and bring private equity real estate firms into direct competition for talent with the wider market. Base and bonus at that point will likely be obsolete and insufficient to attract candidates with a background in technology who are more likely to be at least partially motivated by softer benefits and career opportunities. The word cloud shown here gives an idea of the broader employee incentives advertised on the career sites of top tech firms and EY and shows the extent to which these employers are targeting the goals and aspirations of younger generations. The convergence of real estate, finance and technology as well as other sectors will likely force private equity real estate funds to reconsider remuneration structures to compete not only with technology firms but all sectors.

Softer benefits, clearer career paths and the opportunity for everyone to share in the success of the wider organization will become increasingly important. Creating a deferred compensation structure that is open to all with improved liquidity and scope for more intermittent awards will be an essential tool to compete with the opportunities and rewards on offer to employees elsewhere.

Figure 3: A selection of softer benefits on offer at leading technology and professional services companies





Contacts

EY Global

Mark Grinis
Global Real Estate, Hospitality and Construction Leader
+1 212 773 5148
mark.grinis@ey.com

Dovid Frankel
Global Real Estate Fund Services Leader
+1 212 773 4536
dovid.frankel@ey.com

Rob Otremba
Global Real Estate Fund Markets Leader
+1 202 327 7694
robert.otremba1@ey.com

Henry Stratton
Senior Research Analyst
+44 20 7980 0666
henry.stratton@uk.ey.com

EY Americas

Viktor Andrade
São Paulo
+55 11 2573 3042
viktor.andrade@br.ey.com

Tony Ianni
Toronto
+1 416 943 3476
tony.a.ianni@ca.ey.com

Tom Brown
Atlanta
+1 404 817 4241
thomas.brown@ey.com

Henry Gonzalez
Mérida
+99 992 61 450
henry.gonzalez@mx.ey.com**Josh Herrenkohl**
New York
+1 212 773 3302
josh.herrenkohl@ey.com

Barksdale Penick
Washington DC
+1 202 327 8787
barksdale.penick@ey.com

Chen Shein
Tel Aviv
+972 3 5687101
chen.shein@il.ey.com

EY EMEIA

Kai Braun
Luxembourg
+352 42 124 8800
kai.braun@lu.ey.com

Karl Hamberger
Munich
+49 89 14331 13662
karl.hamberger@de.ey.com

Michael Hornsby
Luxembourg
+352 42 124 8310
michael.hornsby@lu.ey.com

Dietmar Klos
Luxembourg
+352 42 124 7282
dietmar.klos@lu.ey.com

Harry Lang
Berlin
+49 30 25471 21270
harry.lang@de.ey.com

Matt Maltz
London
+44 20 7951 1886
mmaltz@uk.ey.com

Christian Schulz-Wulkow
Berlin
+49 30 25471 21235
christian.schulz-wulkow@de.ey.com

Jean-Roch Varon
Paris
+33 1 46 93 63 89
jean-roch.varon@fr.ey.com

EY Asia-Pacific

Harvey Coe
Hong Kong
+852 2846 9833
harvey.coe@hk.ey.com

Luke McIntosh
Melbourne
+61 438 71 9944
luke.mackintosh@au.ey.com

Seng Leong Teh
Global RHC Lead Advisory Leader
Singapore
+6221 5289 5000
seng-leong.teh@id.ey.com

EYG No. 01313-184GBL
CSG No. 1802-2590390
ED None