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Forming A Real Estate Fund: Key Strategies And Structures

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Forming A Real Estate Fund:
Key Strategies And Structures

In its simplest form, a real estate private equity fund is a partnership established to raise equity for ongoing real estate. A general partner creates the fund and invites investors to add equity to the partnership. These funds, along with money borrowed from banks and other lenders, will be invested in real estate development or acquisition opportunities for investment purposes.

How does one go about creating a partnership to raise equity for ongoing real estate investment?

This article will examine the contemporary structures and strategies most often utilized by private equity real estate fund sponsors and outline the necessary steps to create a partnership and manage the fund. It also discusses the factors that must be considered when setting up a fund and the securities laws that may impact the sponsor and investors of the fund.

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Entity Types

Private equity real estate funds are typically created by using an entity that is either a limited liability company or a limited partnership. Both variations are considered “pass-through entities”, meaning that all gains and losses are attributed directly to the partners or entity members and are essentially disregarded for tax purposes.

Many of these private investment funds are Delaware limited partnerships or LLCs. However, many states have laws that require entities holding real estate for income-producing purposes to be qualified to do business within the state where the real estate is located. Due to the complexities and added expenses in certain jurisdictions, it is important to work with experienced counsel to discuss how entity type and jurisdiction may impact the investment strategy of such funds.

Admission And Withdrawal Of Investors

One of the initial considerations with private equity real estate funds is whether to use an open-end or closed-end fund structure.

While the open-end structure allows investors to enter and exit the fund at regular intervals, the illiquid nature of real estate makes it difficult to establish a fair value for each new or withdrawing investor. The difficulty comes in attempting to provide accurate valuations for incoming investors, since formal appraisals may be the only way to truly assess the value of the fund’s assets. On the other hand, closed-end funds require all investors to join the fun at the same time, thereby removing concerns about the initial value of their investments.

Similar restrictions can be created to match rights of withdrawal, in keeping with the liquidity profile of the fund. Fund sponsors should carefully match the liquidity of a private real estate fund’s investments with the withdrawal rights offered to the fund’s investors.

A third option would be to create “side pockets” for the fund, which essentially allows investors to participate in the assets of the fund on an investment-by-investment basis. Using this semi-open-ended solution means subsequent investors will not participate in the profits and losses from earlier investment assets, but only the assets in which they are funding.

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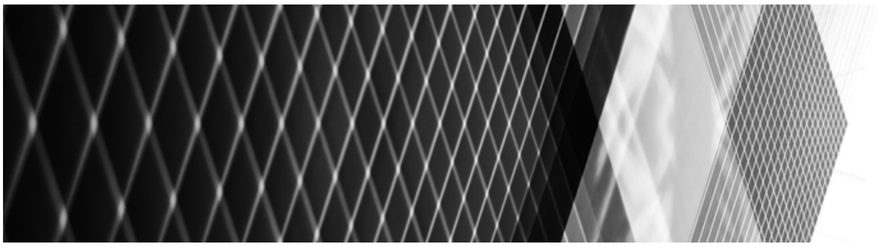
What Is The Difference Between General Partners And Limited Partners?

A general partner (GP), often referred to as the "sponsor", creates the fund, and then asks limited partners (LPs), often called "investors" to provide equity for the partnership. For the purposes of this article, we will refer to general partners as sponsors and limited partners as investors.



What Roles Do Sponsors, And Investors Play In The Real Estate Private Equity Fund?

In general, the investors provide most of the equity capital for the fund but are also passive investors who have elected to participate in the offering presented by the sponsor. Sponsors also provide some of the equity capital, secure the investment opportunities, and manage both the fund and the real estate investments.

Investors earn an early return of capital and a preferred return of capital invested. Sponsors earn fees that are typically based on the fund's performance.

How does a real estate private equity fund differ from a joint venture?

A real estate private equity fund requires an extensive partnership agreement, where each share of equity investment is treated equally even though it is used to invest in a diversity of properties.

Joint ventures are usually designed to provide funding for a specific purpose or single investment, in which each partner provides a specific dollar amount or percentage share.

Real estate funds, on the other hand, are created to provide equity investments toward a series of real estate investments, using a standardized risk and reward structure for the fund, in which the sponsor and investors are equal participants.

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Advantages Of Private Equity Real Estate Funds

- **Diversify holdings:** A private equity fund can identify investment opportunities in their home markets, at scale, that are beyond their typical property focus, outside of their traditional geographic focus, or a combination of the two. Because the fund has the financial resources to take advantage of these opportunities, it can generate returns over a larger base of capital and ultimately reduce the risk to investors.

- **Expand and differentiate funding sources:** By maintaining a pipeline of potential investments, the fund sponsor can optimize a level of deal flow that might be available otherwise. While the options are virtually unlimited, the fund's capital-raising focus should be on the potential for returns and alignment of the teams' interests with clearly identified opportunities.

- **Invest in larger, more meaningful projects:** A sponsor with capital constraints can utilize a private equity fund to invest in larger and more complex developments. By bringing on additional partners, the sponsor is able to share the risks with investors and create a better risk-return balance on larger projects than what the sponsor could take on independently.

- **Obtain better lending terms:** The larger and more diverse a fund's capital base, the less costly any debt or mezzanine capital will be for its sponsor and investors. By incorporating lower-risk projects within the portfolio and securing better lending terms, the equity returns are increased for sponsors and investors.

- **Develop projects using fund-level financing:** Rather than funding each project separately, fund-level financing allows the sponsor to move faster and jump into a rapidly developing market. Funds with permanent financing allow for more immediate engagement with construction lenders and landowners.

- **Earn fees from the fund:** The sponsor might find that its business matures quickly and is now considered the market leader. When this occurs, the sponsor's benefits expand to include a promoted interest and fees, as outlined in the fund structure, as a reward for this success.

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Five Key Considerations

While there are numerous factors to contemplate before setting up a fund, three key considerations are fundamental to establishing the most successful fund and raising sufficient capital from the limited partners. When properly executed, the private equity fund structure provides significant rewards for sponsors, but like any other new venture, it is important to have a clear strategy ahead of time, and to execute against that plan.

Below are five of the main considerations for sponsors to think about when establishing a private equity real estate fund.

1. While proportional to the size of the fund, the lower floor for organizational costs is about $150,000 to $250,000 (depending on the complexity of the operating structure). Sponsors are able to recoup these fees from the fund after capital is raised, but the sponsor must assume these costs during the fund's formation period. These fees include formation costs, accounting fees, filing fees, accounting fees, clearing costs, and regulatory brokerage costs. amount of equity capital to be raised (minimum fund size is generally considered to be $10 million).

2. Well-executed funds must balance the deal flow with the fund size to produce sustainable returns for the investors. Another consideration is the timing of flows to and from the fund since the LPs will soon be earning a preferred return on their capital investments. This is another reason to stage the payments into the fund to match the timing of anticipated investments.

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3 Sponsors must be aware of the amount of time, energy and funding required to launch. A sponsor's responsibilities include:

- Organizing the fund
- Generating a partnership agreement
- Offering and subscription documents
- Securing investment opportunities
- Securing loans and other financing
- Preparing partners' tax returns
- Auditing and accounting matters

4 While experienced sponsors and the largest funds may be able to raise funds for a blind pool – a fund for which no individual investments are identified – first-time sponsors generally must identify specific investments that are included in the fund's offering memorandum.

5 In a private equity fund environment, the sponsor's rights are governed by the terms of the partnership documents, as well as the offering memorandum. As a result, attention to detail must be paramount. A consistent reporting structure, as well as regular meetings with the investors, are important to maintaining unanimity amount the partners.

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Real Estate Fund Structures

Setting up a real estate fund requires legal counsel when setting up the terms of the investment, including the fund's strategy and the specific needs and objectives of the fund. It is crucial that the fund's legal counsel is highly experienced with current market trends within investment markets and how those trends impact the fund's strategy.

One of the main objectives here is to adequately protect the fund sponsor while making the offering attractive to potential investors. Essentially, it is the fund's strategic objectives, as well as the tax needs of its investors, that inform the fund's structure

The three main structures that govern the addition and withdrawal of limited partners (investors) are the open-end structure, the closed-end structure, and successive funds.

In general, most real estate funds are closed-end, or illiquid assets, and are designed to last for a fixed time period, usually between five and ten years. Consequently, investors are generally unable to withdraw funds or add more capital contributions during the life of the fund, and once funded, a capital contribution will only be returned upon the sale or refinancing of an asset in the fund. However, positive cash flow from rents or other income-producing operations could also compensate investors.

Successive funds become available when the sponsor opts to create a subsequent fund to facilitate additional investments. Most successful sponsors will develop a diverse portfolio of funds, which can be used to form subsequent and analogous real estate investments. Because less structuring is required to get started, these funds offer substantial cost savings to the partners.

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Domestic Real Estate Fund Structure

Generally, a domestic-only fund structure will include the following entities:

- a limited partnership to act as the fund entity
- an LLC to act as the investment manager of the fund, within the jurisdiction of the sponsor
- a general partner of the fund or managing member in the case of an LLC, also formed in the sponsor's jurisdiction. However, for real estate funds, the sponsor and the investment manager are formed as two separate entities, which allows subsequent funds to maintain separate sponsors for the purposes of liability.

US Tax-Exempt Investors

Under Section 512(b) of the Internal Revenue Code, certain investment income, including real estate investment income, is subject to the Unrelated Business Income Tax Income (or "UBTI") if the income is derived from debt-financed property. Any such distributions could make the fund subject to UBTI.

Offshore Investors

When structuring a private equity real estate fund, it is important to consider whether to admit offshore investors or rely on US-only individuals. Non-US investors are seemingly underrepresented in US real estate funds, primarily because of the tax complications they face, and the complex structuring needs that must be in place to avoid US tax consequences.

FIRPTA Considerations

It is important to note that the primary concern for offshore individuals considering investment in US real estate funds is FIRPTA, also known as the US Foreign Investment in Real Property Tax Act of 1980. Under FIRPTA, offshore investors are taxed on income from US real property investments, at very high rates. FIRPTA also demands that offshore investors become subject to the IRS's investigatory and subpoena powers.

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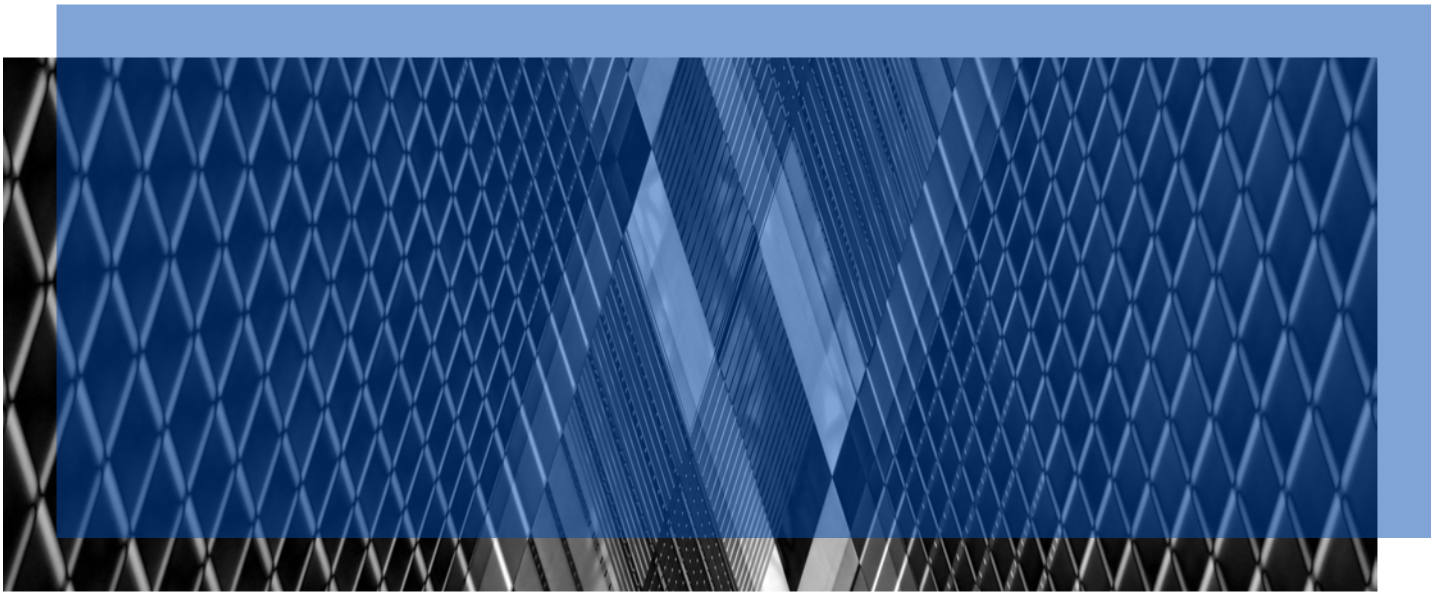
Offshore Fund Structures



One of the most important aspects of forming a real estate fund is setting the terms of the investment. When properly structured, real estate fund offering documents contain terms that adequately protect the fund sponsor and are attractive to investors. Real estate fund terms are driven by the fund's strategy, the market trends within the fund's specific asset class, and the particular needs and objectives of the fund. It is crucial that the investment fund legal counsel have an in-depth understanding of current investment market trends and how those trends affect the strategy the fund will employ.

One way to protect offshore and tax-exempt US investors from US tax liability is to structure the fund offshore. The leveraged blocker structure and side-by-side structure are the most common offshore fund structures.

While most funds will use a master-feeder structure to set up the fund in a tax neutral jurisdiction (the Cayman Islands or the British Virgin Islands) to shield offshore investors, this is not the case with real estate funds. The primary way to reduce the tax exposure for offshore investors is by using a more complex structure known as the leveraged domestic blocker.

What Is The Leveraged Blocker?

A leveraged domestic blocker is usually set up as a Delaware corporation and is capitalized with a mixture of equity and loans.

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The objective of this entity is to shield offshore investors from the obligation to file a US tax return, as imposed by FIRPTA. While the mechanism is complicated, it is worth considering because of the available interest deduction. It also reduces the effective tax rate on real estate fund investments for non-US investors.

The protection afforded by the blocker will depend on the investment and the particular investor, but with proper structuring there is the potential to prevent offshore investors from being subject to FIRPTA.

What Is A Parallel Fund Structure?

Also known as a side-by-side structure, the parallel fund structure has an offshore fund and a domestic fund running parallel to one another, with each one trading and investing under the same investment manager but maintaining a separate portfolio of assets.

Offshore Jurisdictions

Many jurisdictions allow for the formation of offshore funds, including Singapore, Luxembourg, Malta, and others, but most of the offshore funds set up by US investors are located in the Cayman Islands or the British Virgin Islands.

Cayman Islands: The Cayman Islands' business-friendly structure has made it the longstanding choice for offshore funds. Known as the global leader for offshore investment fund location, the Cayman Islands has a stable government and well-developed investment statutes.

British Virgin Islands (BVI): With its cost-effective and convenient regulatory structure, BVI has sought to create a streamlined process and strong legal certainty, making it the most flexible jurisdiction. BVI also offers less expensive filing fees than the Cayman Islands.

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Five Types Of Funds

When forming a private equity real estate fund, the sponsor should clearly communicate where the fund will operate along the risk-return continuum. This will require using one of the five types of funds that exist within the private equity structure. Investors will focus on certain metrics, including equity multiples, returns and sheltered income, to determine which fund best meets their objectives.

1. Core: Typically offers 6 to 7 percent net equity internal rate of return (IRR) through the lowest risks/rewards. These funds usually include high-quality assets in primary markets with premium locations.

2. Core-plus: These funds also contain high-quality assets but usually are located in secondary markets, or with slightly risky assets in primary markets. Offering an 8-12 percent net equity IRR for investors, these funds offer moderate leverage to increase the IRR.

3. Value-add: These funds may include assets that have been improved via operational efficiency, re-leasing, or redevelopment, as well as new development. They employ more moderate leverage of up to 70 percent, with appreciation playing a significant role in the overall return on investment and 11 to 15 percent net equity IRR for investors.

4. Opportunity: These high risk/high return funds involve the repositioning and/or redevelopment of poorly run or outdated buildings, with market/location playing a secondary role to the opportunity for returns, much of which occurs at the end of the holding period. Opportunity funds offer more than 15 percent net equity IRR for investors.

5. Distressed debt/mezzanine: These funds use leverage to increase the equity IRR and would not turn away from loans in default. Sponsors usually purchase senior loans, nonrated commercial mortgage-backed securities (CMBS), or make mezzanine loans. Typically, a distressed debt fund will offer 8 to 12 percent net equity IRR for investors.

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Real Estate Fund Strategies

Real estate funds have been trending toward greater levels of specialization, as has been the case with every type of investment funds. Areas of specialty might be by strategy, class, or both.

A class-specific strategy might include a mix of retail, office, medical, storage, hospitality, industrial and agricultural properties, among others.

The various strategies employed for real estate funds can be loosely categorized into the following categories:

Structured Finance Real Estate Funds

These funds, which seek to use substantial leverage to buy stable real estate assets, are often called leveraged buyout funds. Cyclical by nature, these funds rely on inexpensive access to debt financing.

Distressed Asset Funds

By identifying assets that are over-leveraged or suffering from cash flow issues, distressed asset funds attempt to invest in assets that might otherwise be unable to acquire financing.

Real Estate Development Funds

A development fund is used to acquire and demolish the existing property for re-development. While these funds require substantial involvement in working with municipalities through the various states of construction, they can be a lucrative option for investors.

Joint Venture Real Estate Funds

These funds utilize a strategy of co-investment with other real estate funds to form a syndicated investment. Joint venture funds can often require the investment manager to complete SEC registration requirements, as the co-investment may be considered a security.

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Opportunistic Or Special Opportunity Funds

As the name implies, opportunistic funds focus on special circumstances where assets might be sold at a discount, such as surplus or damaged real estate, a foreclosure, or an unfinished construction project.

Multi-Strategy Funds

These funds are the exception to the trend toward specialization, as they are not confined to a single strategy or objective. Ideal for investors who tend to have a lower tolerance for risk or need to preserve capital, multi-strategy funds have the discretion to employ multiple strategies in a single fund.

Sponsor Compensation

When setting up a real estate investment fund, sponsors should consider their compensation carefully to ensure it aligns with their interests and the objectives of their investors.

Sponsor compensation may be earned from two sources:

- The Promoted Interest, also known as carried interest, generally consists of a two-percent fee based on capital raised from investors, and another 20 percent of the profits from the fund. As a way to align themselves with the interests of investors, sponsors often participate only in those profits which are above the limited partners' preferred return

- Fees: Additional fees may be earned by sponsors for a variety of different services provided to the fun, including the following:

  - Acquisition fees for acquiring buildings on behalf of the fund (1 to 3 percent of the acquisition price)

  - Asset management fees for managing the fund on behalf of investors (1.5 percent of the annual value)

  - Fees for property management, construction, leasing, and development, when provided by the sponsor in lieu of hiring outside firms (typically based on market norms)

  - Finance and guarantee fees for securing financing and providing a guarantee on behalf of the fund (0.5 to 1.0 percent of secured funds)

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Securities Laws, Regulation D And The Offering Memorandum

Please note that any firm considering the establishment of an investment real estate fund should retain experienced legal counsel and a financial team to advise on the capital raising, setup, and administration of the fund.

Regulation D of the Securities Act of 1933

Creating a private equity investment fund can be done without the need to register with the Securities and Exchange Commission (SEC), as long as the offering meets the requirements of Regulation D of the Securities Act of 1933. These requirements were revised by the JOBS Act of 2012, which eased some of the regulations in order to encourage funding for small businesses. In 2016, the amendments were further refined by changing the rules for registration exemptions.

Specifically, Regulation D provides two exemptions from the Securities Act requirement, Rules 504 and 506. It also established two basic investor types: accredited and non-accredited investors. Accredited investors have a personal net worth of more than $1 million, excluding the value of their home, or investors whose annual income exceeds $200,000 over the past two years who expect to continue the same income in the current year. If any of these criteria are not met, the investor will be non-accredited. Any directors, general partners, executive officers, or sponsors, as well as business entities, are considered to be accredited investors regardless of net worth or income.

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What Is Rule 504?

Rule 504 allows the sponsor to raise up to $5 million per year without the need to register with the SEC. Funds can be derived from accredited or non-accredited investors, and the sponsor not required to file any specific disclosures. In addition, the offering is “restricted”, meaning that interests granted to LPs may not be sold without first being registered.

Under Rule 504, sponsors may not solicit or promote the offering of interests to the public unless certain requirements are met. For one, sponsors must abide by legal exemptions based on state securities laws, known as Small Corporate Offering Registration (SCOR), and may advertise the offering as long as the sponsor sells only to accredited investors.

What Is Rule 506?

The SEC’s Rule 506 allows sponsors to raise unlimited capital, provided they follow a very specific set of rules, within Rules 506(b) and Rule 506(c).

With this rule, sponsors may offer the fund to a maximum of 35 non-accredited investors and an unlimited number of accredited investors. Any non-accredited advisors will need to seek the advice of an investment advisor or be a sophisticated investor themselves. The SEC considers someone a sophisticated investor when he or she has sufficient experience and knowledge of financial and business matters to make wise evaluations about prospective investments.

While there are no set rules for how a sponsor must disclose investment information to accredited investors, the SEC requires significant disclosures for non-accredited investors. These disclosures are similar to what is required for a registered offering. Additionally, any disclosure provided to non-accredited investors must also be provided to accredited investors.

Rule 506 also requires sponsors to be available to answer questions from prospective purchasers. Further, the rule prohibits them from soliciting investors or advertising the offering unless all investors in the fund are accredited, and the sponsor verifies that each investor meets the necessary criteria for accreditation. Investors are also prohibited from selling their interests for at least one year.

Regardless of which SEC rule is used for the offering, sponsors must be conscious of these four items that might impact private placements:

- Sponsors must file with the SEC within 15 days of the first sale of an interest.
- Sponsors must not violate the antifraud provisions of the federal securities laws.
- Sponsors may not “game the system” by creating multiple offerings that are the same.
- State “blue sky” laws must be followed.

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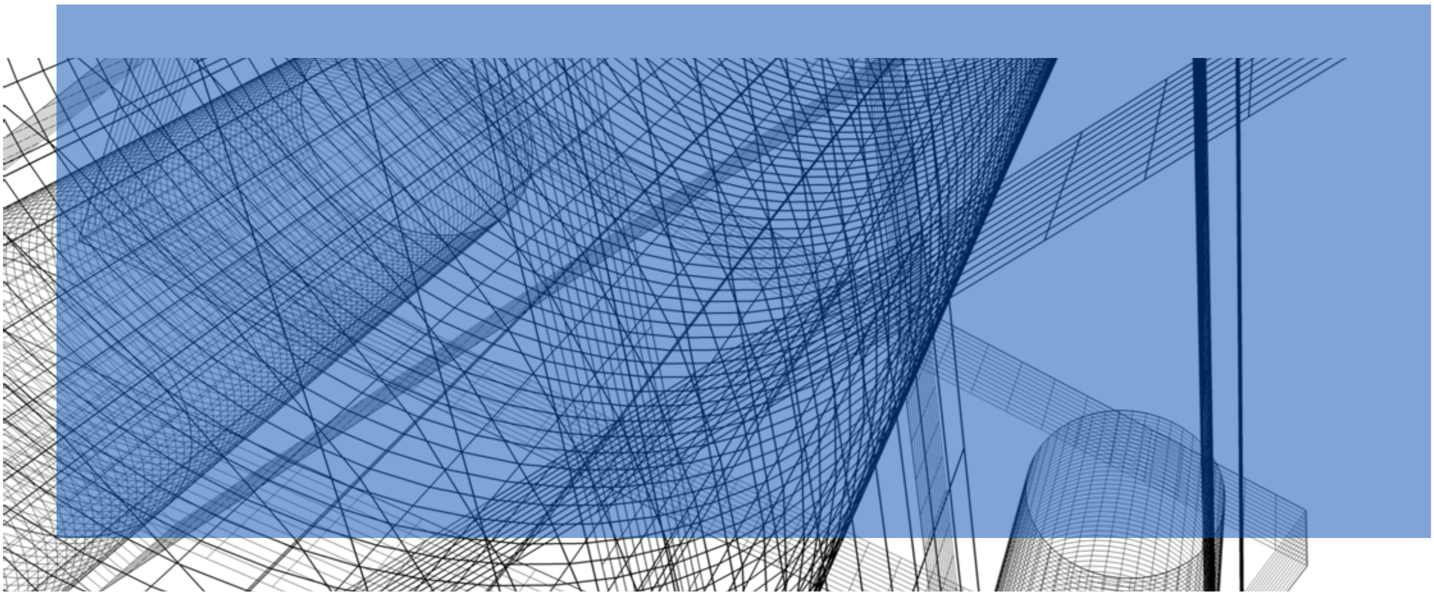
Operating The Fund



For the first-time sponsor, it is important to note specific factors related to operating a fund with outside investors.

Closed-end funds make contributions to real estate funs simpler, especially when raising funds for a specific investment or set of investments with a fixed number of partners. The use of such a structure eliminates the need to frequently appraise the fund for add-on investors. Generally, each partner makes an initial contribution, followed by additional funds as set forth in the development schedule. Most sponsors will schedule of preplanned "calls" for capital funding, which specify the amounts, dates, and terms of each round of funding.

Allocation of profits and distribution of cash flows are also performed according to the terms set forth in the offering memorandum, and usually include the investors' preferred return and share of net profits.

Most fund participants will prefer to receive these in the following order:

- Sponsors and investors receive a return of their capital contribution.
- Investors receive their preferred return, which is calculated based on the total amount of capital held and the time period in which the funds were held.
- Sponsor receives a "catchup", or allocation of the profits.
- Investors and sponsor divide the remaining profits or promoted interest, according to the agreed-upon structure.

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Fund Expenses

Part of the formation process includes the designation of how the expenses will be borne by the fund and the manager. Generally, the fund will bear only the expenses related to its formation and operation, including legal, accounting, and administrative costs, regulatory filings, clearing costs and brokerage fees.

The sponsor of the fund will receive compensation that includes carried interest and certain other fees, depending on the sponsors level of involvement with day-to-day operations. The most basic fee is for the management of investments, which typically ranges from 0.5% to 2%. Other fees are outlined above (see "Sponsor Compensation") and include property management, leading fees, finance and administrative fees.

Capital Commitments

Upon subscribing to an investment in a private equity real estate fund, investors usually commit to invest a certain sum, or capital commitment, within a specific timeframe by the sponsor (a capital call). During a capital call, the sponsor will specify the capital commitment percentage of each investor, after which the investors have a set period of time to contribute.

Once the investor contributes capital, it will only be returned upon a "capital event" such as a sale or refinancing of the assets in the fund, or events resulting from positive cash flow in the fund.

Preferred Return

As stated earlier, most real estate funds will include a preferred return for investors, which can range from 6-12 percent of their capital contribution. These returns are accrued and compounded on an annual basis and distributed according to the provisions for capital event distributions.

Preferred Return

A real estate fund's offering memorandum should also include the distribution provisions that will occur in relation to capital events. The prioritizing of distributions between the general partner and limited partners is known as the distribution waterfall, which refers to a set of allocation pools. As soon as a higher priority pool is full the capital flows into the next pool.

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While the definition of pools varies greatly from one fund to another, they generally fall into the following framework.

Phase one: Preferred return and recovery: Investors receive distribution first, until their capital contributions and preferred return are paid in full

Phase two: Catch-up, where the remaining funds are split between the investors and the sponsor, in the form of carried interest. However, in this phase, the sponsor usually receives more allocations at the catch-up rate until the allocations for carried interest is caught up.

Phase three: Carried interest, which begins immediately after the catch-up phase, is where capital allocations are distributed based on the carried interest, typically 20 percent for the sponsor and 80 percent for the investors.

General Partner Clawback

Once the fund has been liquidated, limited partners have often received less than their promised allocation. This occurs when the fund had more positive performance in the beginning than at the end. When this occurs, the investors will “clawback” any unpaid amounts from the carried interest that was distributed to the sponsor. Fund sponsors must be prepared for this and maintain sufficient reserves, usually in escrow, to satisfy these financial demands.

Clawbacks may be found in funds where multiple investments are held, to provide a solution for investors who do not receive the return of their entire capital contribution and preferred return.

Side Letters

Lastly, most offering memoranda will specify that the management team must negotiate special terms, also known as “side letters”, which are not available to other investors. These special arrangements often include better economic terms for specific participants. It is important to note that side letters may not prejudice other investors by providing additional disclosure rights or preferential allocations.

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Conclusion

The private equity real estate fund enables a sponsor to generate capital, at scale, within a pooled fund, thereby avoiding the need to raise money on a deal-by-deal basis. It also avoids the complexities and substantial regulations involved in forming a REIT.

Establishing a real estate fund is a big step, even for the most experienced real estate or investment professional. This article is meant to demystify fund formation and operation, but it is no substitute for retaining experienced legal counsel.

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