AN INTRODUCTION TO REAL ESTATE SYNDICATION

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WHAT IS REAL ESTATE SYNDICATION?

INTRODUCTION

A real estate syndication is an aggregation of money from multiple investors for the purpose of investing together in a specific real estate opportunity, for example, a commercial office building or an apartment complex. Real estate syndication is an effective way for investors to pool their capital and invest in opportunities that are much bigger than the opportunities those investors could afford or manage individually. Think of syndications like a group of friends and family pooling their capital together to make an investment - however, syndications are organized by "sponsors," who are most commonly experienced real estate professionals, and the investors are generally unrelated to one another.

The person who organizes a syndication can sometimes be called the syndicator, sponsor or promoter. I will use these terms interchangeably but will most often use the term sponsor. Real estate syndications are typically in the form of a limited liability company (LLC) or a limited partnership (LP). The syndication will have a manager (if an LLC is used) or a general partner (if a LP is used). The sponsor is typically a different entity from the manager or general partner; however, the manager or general partner may be wholly owned by the sponsor. The sponsor is typically comprised of multiple owners and includes the team members who, through the manager or general partner, will collectively manage the syndicate.

HOW DOES A REAL ESTATE FUND DIFFER FROM A REAL ESTATE SYNDICATION?

I will use the terms syndicate or syndication and fund interchangeably in most cases, and the use of such terms will refer collectively to real estate syndications and real estate funds. I may also use the term issuer to refer to the specific LLC or LP that is issuing the securities in connection with the fund. However, there is a significant difference between a real estate syndication and a real estate fund. A real estate syndication is an investment vehicle formed for the purpose of pooling capital from investors with the goal of purchasing, rehabbing, owning, operating and selling one or more already identified properties.

In a real estate fund, the money is raised before any properties are identified. That is, a real estate fund is an investment vehicle formed for the purpose of pooling capital from investors in order to invest in one or more real estate properties that are not identified beyond the type of real estate assets and the criteria to be used to select the specific real estate assets later on. The sponsor invests the pooled capital based on the fund's investment objectives, which can be extremely broad and diverse. The criteria to be used in selecting a specific real estate asset is often called the investment strategy. In essence, funds are a "trust me" vehicle that require investors to invest capital based on the trust investors have in the vision, reputation, credentials, strategy and track record of the sponsor. A blind pool fund can be a harder vehicle to raise capital for because it's a trust vehicle, as opposed to a traditional real estate syndication where the investors can evaluate the specific property or properties at the same time they evaluate the sponsor – before investing.

WHO ARE THE PARTIES INVOLVED?

In the simplest sense, syndicates involve two main parties: the sponsor and the investor. Based on the form of the syndicate and sponsor, though, additional parties come into play, including the manager/general partner, the syndicate or issuer, and in some cases, a special purpose entity.

SPONSOR

The sponsor is the main real estate investment company that, in most instances, was founded previously by one or more persons for the purpose of investing in real estate assets. The sponsor has likely been doing business for a while either through the use of the founders' own money in addition to one investor per real estate asset or through debt in the form of traditional commercial, private money loans or hard money loans. The sponsor will be the entity where the employees reside. Inevitably, most sponsors reach a point where the sponsor wants to grow and scale its real estate investing business, and to accomplish that, the sponsor turns to syndicating deals. The sponsor could be structured as a limited partnership, a limited liability company or a corporation.

MANAGER / GENERAL PARTNER

The manager or general partner is an entity generally wholly owned by the sponsor, which serves as the manager if the fund is an LLC or the general partner if the fund is a LP. The manager or general partner typically has broad powers when it comes to managing the fund. Those powers are described in both the private placement memorandum of the fund as well as the operating agreement if the fund is an LLC or the limited partnership agreement if the fund is a LP. The manager or general partner is most often structured as a limited liability company.

ISSUER

The issuer (the fund) is the investment vehicle. The investors will invest capital in exchange for an ownership interest in the fund (if the fund is structured such that it is selling equity ownership interests) or the investors will invest capital in exchange for a promissory note (if the fund is structured such that it is selling promissory notes instead of selling equity ownership interests). The issuer is generally structured as an LLC or LP.

INVESTOR

Investors are those persons or entities that invest capital into a fund so that the fund can use that capital to purchase real estate assets as described in the issuer's private placement memorandum. If the investor holds an equity ownership interest in a limited liability company, the investor is called a member. If the investor holds an equity ownership interest in a limited partnership, the investor is called a limited partner. With the exceptions of those syndications conducted under Regulation A+, Regulation Crowdfunding or certain Regulation D, Rule 506(b) offerings, investors will be accredited investors.

SPECIAL PURPOSE ENTITY

Some syndications may elect to hold the underlying real estate asset in a separate, special purpose entity that is wholly owned by the issuer. This is most often the case for larger real estate assets. A special purpose entity adds layers and complexity to the structure, but the purpose of doing so is to help provide additional liability protection to all the parties involved; in the event of an issue with one real estate asset, the other real estate assets shielded in unrelated and separate entities. If the issuer is borrowing money for the acquisition or rehabilitation of the real estate assets, the lender will often require that the property be segregated and held in a special purpose entity.

COMMON STRUCTURES OF SYNDICATES

There are two structures that are common in many real estate syndications. The one class structure and the two-class structure.

ONE CLASS STRUCTURE

In the one class structure, there is only one class of equity in the issuer. Investors purchase equity in the issuer and the manager/sponsor may or may not purchase equity in the issuer. In the one class structure, the manager/sponsor does not hold its equity interest, if any, in a separate ownership class within the issuer.

TWO CLASS STRUCTURE

The second structure is a standard two class fund structure, in which the manager, sponsor or a separate holding company wholly owned by the sponsor owns an ownership interest in a separate class from the investors. The use of a two-class structure is also used in instances where the manager, sponsor or a separate holding company wholly owned by the sponsor is not making a capital contribution to the fund. For example, the manager, sponsor or a separate holding company wholly owned by the sponsor owns Class B Units and the investors purchase Class A Units as part of the offering. Common reasons for using the two class fund structure are (1) the ownership of Class B Units by the manager, sponsor or a holding company owned by the sponsor preserve distributions for the sponsor if the Manager is removed; and (2) segregating fees from distributions so that earnings on distributions through the ownership of Class B Units may be taxable at capital gains rates, versus manager's fees, which will be taxed as ordinary income.

WHAT ARE THE THREE GENERAL TYPES OF SYNDICATION OFFERINGS?

There are three general types of syndicates – specified, semi-specified and blind pool. Each has its own characteristics which are explained below. Determining which is right for the sponsor is a discussion for the sponsor to have with its team, including the sponsor's securities counsel. Before making a decision, the sponsor should evaluate the pros and cons of each offering type in light of the sponsor's experience level, track record and property type.

SPECIFIED OFFERING

A specified offering is one in which the real estate that will be owned by the issuer is identified before capital is raised from investors. A specified offering typically involves one property but could also involve multiple properties.

A specified offering is for a sponsor that has one or more commercial properties under contract but needs to raise money from investors to complete the acquisition. Typically, in a specified offering, the sponsor will use its own money for items such as the earnest money deposit, conducting due diligence, legal fees and similar expenses. The sponsor will not use investor funds until the closing. The sponsor does that to ensure that it can return the investors funds if the closing does not occur. Once the property is acquired, it is standard for the investors' funds to be used to reimburse the sponsor for all of those out-of-pocket costs and expenses incurred by the sponsor in connection with the acquisition of the property.

In a specified offering, the sponsor will prepare a specific property information packet that will accompany the legal documents.

SEMI-SPECIFIED OFFERING

In a semi-specified offering the sponsor has identified some, but not all, of the properties that will be included in the offering. A semi-specified offering requires the sponsor to have at least one property that is under contract as well as an investment strategy that describes the criteria for additional properties (which are typically similar to the one under contract) that the sponsor plans to acquire as part of the same offering. A semi-specified offering allows the sponsor to raise capital to close on the property under contract and continue raising capital to investigate additional properties for acquisition.

In a semi-specified offering, the sponsor will prepare a specific property information packet with respect to the property that is under contract as well as an investment strategy detailing the type(s) of real estate assets the fund will additionally be investing in. For example, if the business plan discusses investing in multifamily apartment complexes, the fund will typically not have the right (via the legal documentation) to acquire commercial office buildings or retail strip malls. This ensures the investor knows exactly what types of properties may or may not be acquired by the fund.

Investors do not have as much control, compared to a specified offering, when investing in semi-specified offerings, but there are benefits.

- Sponsors can act quickly to acquire additional properties. As opposed to raising money for each individual property, which can be time consuming, the sponsor, with funds in hand, can shorten the contract period and be more competitive in the marketplace when investigating new acquisition targets.
- Most sponsors who conduct semi-specified offerings have a history of investing in real estate (usually the same type of real estate the issuer will be acquiring), and therefore, investors should have increased comfort that the sponsor will make decisions on the investor's behalf, while staying within the guidelines of the issuer's strategy.
- Because a semi-specified offering involves more than one property, the investor's capital is diversified. Although the assets may all be within the

same real estate asset class, multiple properties lead to a more diverse use of the funds within that real estate asset class than only investing in one property.

- At least one property will have been identified so investors will be able to analyze the identified property before making a decision to invest in that property.

BLIND POOL

Blind pools are called real estate funds or blank check funds. Investors in blind pools put up their money without knowing what specific properties will be acquired. Blind pools can be very large both in terms of the amount of money raised and the number of investors involved. A blind pool typically provides the sponsor with broad discretion to make investments, subject to the investment strategy spelled out in the offering documents.

Most investors view a specified offering as less risky than a blind pool. Some of the key considerations that investors will evaluate to understand a blind pool prior to investing include:

1. What is the track record of the sponsor with this type of asset class?
2. Does the sponsor have a track record with offerings?
3. What is the investment philosophy of the sponsor?
4. How is the sponsor, manager or general partner compensated?
5. What is the term of the blind pool?
6. What is the investment period?
7. Will funds be reinvested if a property is disposed of during the term?
8. Are there limits on the deal size?
9. Are there limits on the amount of leverage the blind pool can incur with respect to a real estate asset?

A blind pool allows a sponsor to raise capital from investors solely on the sponsor's investment strategy, which should describe the type of properties the sponsor intends to acquire, the geographic area of the properties to be acquired, the exit strategy associated with the properties and other important characteristics associated with the real estate the sponsor will be acquiring. A blind pool works best for sponsors who have a successful track record of investing in the real estate asset class that is described in the investment strategy.

Since the sponsor is raising capital before identifying the specific real estate assets the issuer will purchase, the sponsor can usually use raised capital for deposits, due diligence costs and legal fees before closing on the purchase of any property.

Blind pools are more flexible as they can concentrate on real estate assets that have high yields and can pivot quickly if the market changes. But a blind pool is only as good as the sponsor. If the sponsor's team is unqualified or unethical, the blind pool is not likely to be successful. While the provisions of the investment strategy in a blind pool can be restrictive, well-crafted and thoughtful, investment strategy can also help limit the risk to the investors. The investment strategy reduces the chances of sponsor error and overzealous purchases, forces diversity and bolsters total returns.

In a blind pool, deal flow is key. Once the sponsor raises the capital, the sponsor needs to put that money to work as quickly and efficiently as possible in order to generate returns.

OPEN ENDED / CLOSED ENDED FUND

Since investments in real estate are illiquid, funds have many unique structural issues that must be addressed. An initial consideration is whether to use an open-end or closed-end structure.

WHAT DOES OPEN ENDED MEAN?

An open-ended structure often has an infinite lifetime (this may also be referred to as evergreen) and is designed to offer investors the possibility to buy and redeem their ownership, enabling them to enter and exit (subject to compliance with securities laws) the fund over time. The manager manages redemptions and the fund grows and shrinks depending on new subscriptions and redemptions. But the ability to enter and exit the fund can be hindered by market circumstances. Redemption levels can be capped or frozen to allow the manager to manage redemptions and balance the interests of continuing and exiting investors. Managers can also choose not to accept new subscriptions, for example, if the fund has surplus cash to invest.

An open-ended structure does not work for a specified offering or real estate syndication where the sponsor is raising capital for one or more specified real estate assets to be held for a predetermined period of time. An open-ended structure, however, works for a fund where the fund buys and sells real estate intermittently (rather than just buying and holding for the long term). As such there will be periods of time when the capital is not fully deployed into real estate assets and thus unavailable to fulfill redemption requests.

A redemption plan is an important consideration and tool as the sponsor raises capital, but it is extremely important to consider the structure of any redemption plan. In addition, any redemption plan should be flexible, providing the manager with broad discretion based on the circumstances at the time of a redemption request and the cash reserve needs for the fund.

WHAT DOES CLOSED-ENDED MEAN?

A closed-ended structure has no redemption mechanism. The investor comes in and cannot redeem its ownership interest during the life of the fund. A closed-ended structure has a finite lifetime, typically around seven to ten years. The closed-ended fund usually has a defined investment period of two to five years during which the capital is invested in real estate assets. Closed-ended funds may also define a fixed re-capitalization period: if an asset is sold during the period, it will be reinvested, but if an asset is sold after the period ends, the capital will be returned to the investors.

Investing in real estate has numerous benefits, including cash flow, tax savings and a hedge against inflation. But investing in real estate syndications, specifically, provides additional benefits, which include the following:

1. **Sponsor expertise:** Investors can benefit from a sponsor's expertise.
2. **Diversification:** Unless you are investing in a syndicate with only one asset, investors can achieve good diversification through investing in a fund.
3. **Access to large investment opportunities:** For many individuals, investing in a fund allows them to own a piece of something much larger than what they could afford on their own.
4. **Passive investor:** Investors in funds are passive investors. The sponsor, manager and its management team are actively involved in the day-to-day operations and management of the fund, while the investor takes a passive, uninvolved role.
5. **Attractive returns:** Properly managed funds can offer attractive double digit returns to investors.
6. **Capital appreciation:** Investors generally experience capital appreciation through the indirect ownership of real estate assets.

A closed-ended structure is better suited to a true real estate syndicate where the sponsor is raising capital for one or more specified real estate assets to be held for a predetermined period of time. In such a fund, virtually all of the capital is committed, whether it be for acquisition of property, property rehabilitation, ongoing property expenses or reserves; thus, there is no capital available to fulfill a redemption request.

Just as with any type of investment, there are also risks associated with investing in a fund, including the following:

Lack of control: As a passive investor, the investor is putting trust in the sponsor's skill and judgement. In most funds, investors have very limited voting rights and virtually no control of day-to-day operations of the fund.

Illiquid investment: A fund investment is an illiquid investment. An ownership interest in a fund is usually subject to significant transfer restrictions by the fund's governing documents. In addition, federal and state securities laws also restrict the transfer of an ownership interest in a fund.

Visibility to fund operations: Investors will generally only receive reports on a set schedule outlined in the fund's offering documentation; thus, it can be easy for fund managers to manipulate reports if the manager is unethical.

New fund managers: New fund managers do not typically understand the business side of managing a fund, which is very different than managing the real estate operation.

WHEN IS A GOOD TIME TO SYNDICATE AND WHY SHOULD I SYNDICATE?

Real estate entrepreneurs come from many different walks of life. Some worked for a real estate investment company, as a banker, lawyer, real estate broker or in another professional capacity related to real estate. And some are making the leap from a completely unrelated profession. Most real estate entrepreneurs start out small, fixing and flipping single family residential properties, buying small multifamily units or apartment complexes or buying a few real estate secured notes. Most use their own money initially or get money from family and friends with one investor per deal, typically structured as a private money loan secured against the real estate asset. Over time, as the entrepreneur's reputation grows, and if they are ambitious or hope to take their business to the next level and make a full-time career out of real estate investing, the model of one investor per deal will eventually no longer work without relationships with unlimited supplies of capital. If the entrepreneur has reached their capacity, the entrepreneur must seek out referrals or new relationships with private money lenders or partners, in order to keep growing the business. Developing these relationships can be time consuming and requires a new level of presentation and commitment on the part of the entrepreneur.

The real estate entrepreneur may reach the point that he or she is not able to close on a deal because there is no capital available to them. This presents a dilemma if the entrepreneur comes across too many deals that it cannot close because of lack of capital. The solution to this dilemma typically is to syndicate.

There are many different reasons someone would syndicate. In my experience, the following are some of the primary reasons:

Control – If you are a real estate entrepreneur using a single investor on every deal, the back and forth over terms and underwriting standards can become overwhelming and restricts your ability to expand. Once you have systems and processes and become an experienced deal maker, it becomes easier to quickly identify good deals. Being able to pull the trigger on good deals immediately, without the back and forth that can take place with individual investors, is an enormous advantage and presents an extremely convincing argument to syndicate.

Capital at the ready – In hot real estate markets, competition for real estate assets is high. Speed is often the reason why an entrepreneur beats out the competition. Working under the one investor per deal model does not lend itself to being able to close deals quickly. While the real estate entrepreneur still has to raise capital for the syndicate, once the capital is raised, it is available to close on those good deals.

Make more money – While starting a syndicate does not always result in the sponsor earning more money, the perception is that it will. The ability for the sponsor to raise more capital with a syndication depends on a number of factors, including the asset strategy, the fees being charged to the syndicate and the size and scale of operations.

Grow operations – Starting a syndicate will typically allow the sponsor to expand and grow its operations, which can through expanding outside of the sponsor's current geographic area or through the number of real estate assets or larger projects that the sponsor is able to undertake.

WHAT TO BE READY FOR WHEN STARTING A SYNDICATE?

Given the time, expense and commitment involved in starting and managing a fund, being thoroughly prepared before jumping in cannot be overstated. Before sponsors embark on the journey, there are a host of issues that must be addressed, vetted and decided. Below, I highlight some of the more important issues that should be thoroughly considered in advance of starting a fund.

1. Make certain you have the appropriate staff in place (or the ability to quickly ramp up) to manage the increased workload on the accounting, reporting and investor relations pieces. Some investors will be hands off, but other investors will want to call your office and discuss various aspects of the fund.
2. The level of scrutiny you will be under will increase tenfold. Not only will your offering documents be scrutinized but the background and experience of the sponsor's management team will also be scrutinized.
3. Sponsors that invest in their own syndications will experience an easier time selling the syndicate to investors than those who do not invest in their own syndicate.
4. You may be great at selecting and managing real estate investments, but starting a syndicate is also about being a custodian of investor capital.
5. If your investment strategy is multi-family real estate assets, do not buy an industrial park. Stick to your outlined investment strategy.
6. You need to demonstrate the ability to see the entire process through, from raising the capital, to acquiring the asset, managing the asset and liquidating the asset. Investors are entrusting their capital to you, and if

you are unable to demonstrate your staying power, investors are not likely to invest their capital in your fund.

7. Transparency throughout the life of the fund is key. Investors do not like bad news, but investors prefer to know and understand the bad news up front, as opposed to having the bad news hidden from them.
8. Communicate with your investors on a consistent basis. If you say you will issue a report to investors on a quarterly basis, make sure you issue a report to investors on a quarterly basis. Consistency is important to investors.

Real estate syndications have been around for almost a century now. One of the greatest benefits of real estate syndication is that it allows individual investors to participate in larger, and more stable, multimillion-dollar transactions that they otherwise could not afford.

Because syndications involve the sale of securities and are, thus, regulated by federal and state securities laws, sponsors should always consult with experienced securities counsel before making any offer or sale of an interest in a limited partnership or limited liability company in connection with any real estate syndication.

ABOUT THE AUTHOR

As a results-oriented dealmaker, Jason enjoys creating solutions that bring together great people, projects and capital.

When working on sophisticated business and financing transactions, Jason focuses on the big picture to ascertain his clients' strategic business direction and formulate risk mitigation strategies to protect corporate capital and profitability. His extensive experience includes advising businesses, lenders, investors, startups, and real estate investment companies and developers across the United States, on business transactions from formation to exit, acquisition, due diligence, real estate securities offerings, joint ventures, disposition and financing of real estate.

Passionate about real estate investing, Jason frequently speaks, writes and teaches on the topic, and is also a real estate investor himself. He has authored two books about private money lenders and is working on an eBook focusing on real estate syndication. Jason leads Foster Garvey's Real Estate Funds & Syndications Team.

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