The Rise of Real Estate Funds – How Real Estate Investors Can Efficiently Raise Capital to Facilitate Development and Acquisitions

Article
April 20, 2020

Real estate funds have been on the rise in recent years for a variety of reasons including deregulation, low interest rates, investors seeking a higher return on investment, and a desire by many investors to invest in tangible assets rather than stocks and bonds. With recent economic fallout from the COVID-19 pandemic and its effect on the stock markets, real estate funds are becoming an even more popular alternative for investors seeking diversity and hard asset investments. Despite the increase in popularity, a number of real estate developers and investors have not utilized the real estate fund structure even though it could make the developer and investor more successful in closing transactions and make their capital raising efforts more efficient.

A real estate fund is a private equity fund that invests primarily in real estate based assets. These real estate based assets may include fee interests, tenants-in-common interests, leasehold interests, lien-hold interests (mortgage lien or land-contract interests), joint ventures, and other similar interests. Properly-structured, smaller real estate funds generally fall outside of the regulatory regime imposed on private equity funds that buy, sell, and invest in businesses and the securities related thereto. As such, a real estate fund, especially one with limited investors (100 investors or less) or limited assets under management (less than $150 million), can be formed in much the same way as a traditional real estate investment play.

Generally speaking, real estate funds are formed, and can be structured, like a traditional real estate development or investment project. The sponsor forms a limited liability company or limited partnership in which the sponsor is the manager or general partner, and the investors are members or limited partners.

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There are numerous benefits to starting a real estate fund. First and foremost, the sponsor only needs a one-time primary raise of capital. This frees the sponsor of some significant time burdens involved with consistently meeting with investors on each and every project. Much like a traditional real estate project, this capital is often raised through a private placement to accredited and/or sophisticated investors utilizing Rule 506(b) or 506(c) under Regulation D of U.S. securities laws. Once the capital is raised, or at least enough of the capital is raised that the sponsor feels confident that the fund will raise sufficient funds to accomplish its intended purpose, then the sponsor can begin the process of searching for projects. Real estate funds can deploy the capital in a variety of ways, including acquisitions, developments, joint ventures, secured loans, and preferred equity positions. This benefit is even more valuable in the current environment where the COVID-19 pandemic has resulted in underwriting standards being substantially tightened.

While requiring more in organizational fees in the early stages, real estate funds tend to be a more efficient use of funds over the life of the fund because the investment disclosures are completed at the outset and do not need to be redone for each potential project. Real estate funds may also be able to get better pricing on transactions and better financing terms. By having large pools of capital ready to be deployed, real estate funds can close in cash with shorter due diligence periods and then put mortgage debt on the project after closing. This allows for better pricing due to the seller's confidence that the deal will close quickly and better loan terms because of the ability to shop around for the best loan terms available. A fund also allows for utilizing different types of loans, such as non-recourse loans, because there is not a compressed timeline for closing on such financing.

Finally, in addition to cost benefits, real estate funds may be able to provide better returns and reduced risk to their investors through diversification of the investments. This diversification can take the form of both asset type and investment form. By having a single investment vehicle owning different real estate asset types (e.g., retail, industrial, medical office, etc.), the fund can capitalize on the strength of each asset class at different times during an economic cycle and spread the risk of asset types across stronger performing asset types. Real estate funds can also diversify their form of investment, which can also have the effect of lowering the overall risk profile of the fund. The investments can take the form of senior debt, fee ownership, leasehold ownership, preferred equity, or other forms of investment into a real estate transaction.

While there are numerous benefits to a real estate fund, there are some downsides. First, the additional upfront costs to form the entities and prepare the disclosure documents may be significant. Due to the flexibility of the fund, care must be taken to fully disclose the scope and potential scope of the investment as well as the extent of the discretion retained by the sponsor. Investment criteria must be determined and disclosed in a way that investors will

be enticed to invest, but it is recommended that it be flexible enough to allow the sponsor to take advantage of opportunities that may arise outside of the strict investment criteria of the real estate fund.

Due to the large sums being raised at one time, additional infrastructure may be required to manage investors and the funds. Often real estate funds will not collect the entirety of investments at the outset, but will obtain commitments to make investments and will then call capital when a potential investment is found. Managing investors and keeping them informed will be important to ensure that when a capital call is made, the investors contribute the necessary funds.

In addition to the practical drawbacks, legally there are some additional concerns. As with any security, disclosures must be done correctly and must comply with regulatory requirements. There may be heightened fiduciary duties owed to investors due to the increased sponsor discretion. The private placement memorandum must clearly define the proposed investments and the operating agreement must address situations when an investor fails to timely respond to a capital call by the sponsor or developer. Also, it will be important to continuously evaluate the form of investment, number of investors, and whether the real estate fund is still exempt from the regulatory burdens traditionally associated with private equity funds.

Real estate funds offer an opportunity for seasoned real estate developers and investors to efficiently raise large sums of capital without the increased regulatory burden that traditionally affects private equity.