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Tips For Forming A Real Estate Fund

By **Matt Ertman and Max Brunner** (January 14, 2021, 5:45 PM EST)

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The COVID-19 pandemic has resulted in seismic shifts to the real estate industry over the last year. Shifting preferences and governmental restrictions severely impacted retail, hospitality and commodity office asset classes.

However, there are still many opportunities for investors that have the demonstrated ability to unlock value in difficult market conditions. After an initial downturn last year, the strong recovery in stock markets has made it clear that investors should get off the sidelines and find ways to deploy their capital.

If you have been active as a real estate investor recently, you may be interested in taking the steps necessary to form a multi-asset real estate fund.

There are a few reasons to raise a real estate fund.

You can commingle capital for multiple unidentified investments. It is also crucial to act quickly on valuable distressed properties in the current market with dedicated capital. Real estate as an asset class also has beneficial characteristics such as low or negative correlation with other asset classes, low volatility and ability to generate a risk-adjusted return on investment.

The process of raising a fund may provide future protection and flexibility through the diversification of capital sources and relationships. Even if you have a dedicated capital partner, it's not always ideal to depend on one investor for all your investment needs.

Finally, having one or more funds may allow you to build a brand identity as a fund and asset manager. Especially as you grow your track record and assets under management, your management company can develop a reach and reputation that grows far beyond any one individual.

What structure should you use to set up the fund?

Most real estate funds are organized as Delaware limited partnerships for a number of reasons, such as beneficial flow-through tax treatment for investors, flexibility in accommodating numerous types of investors and investment structures, and the ability of the sponsor to limit fiduciary duties to those specified in the limited partnership agreement governing the fund.

Delaware case law has a long history of interpreting almost every aspect of partnership organization and operation, and Delaware courts have a historical tradition of issuing reasoned written opinions supporting their decisions.

Over time, a significant body of precedent has accumulated providing greater predictability for the resolution of disputes. There is also little to no risk of liability for limited partners beyond the capital they've committed to the fund.

What kind of investors should you look for?

Before forming your fund and preparing organizational and offering documents, you need to consider what type of investor you want to attract — individuals or institutional investors — because this choice will affect the fund documents required.

Individual Investors

You can find individual investors through your network of family, friends, past investors and clients, registered investment advisers with whom you have relationships, or even crowdfunding platforms.

Individual investors tend to negotiate the investment terms and fund documents less than institutional investors. However, raising smaller capital amounts from a lot of individual investors can require significant administrative and investor relations efforts during the term of the fund as well as greater risk of capital call defaults.

Note that if you find investors through advertising or a crowdfunding platform and intend to rely upon the federal Regulation D private placement securities exemption, you will not be able to rely upon investors self-certifying as to their accredited investor status and will need to verify that investors in the fund are accredited.

Institutional Investors

Institutional investors generally make larger investments and in return demand greater sponsor concessions on investment terms. These concessions can be made in the partnership agreement and subscription documents or via side letter.

Some of the most common terms in side letter agreements are:

- MFNs — these most-favored-nation provisions specify that if the fund negotiates separate rights for another investor, the side letter party is entitled to the same or better rights;
- Reduced fees — lower management fees, portfolio fees and/or carried interest;
- Co-investment rights — a right to co-invest with the fund on investments that require more fund capital than the fund manager is willing to commit, often with reduced or no management fees or carry;
- Future capacity rights — the right to invest capital on similar terms in future funds formed by the sponsor;
- Advisory committee seats — the right to appoint one or more representatives to a fund advisory board;
- In-kind distributions —prohibitions on distributions of fund assets in-kind to the investor;
- Preapproved transfer rights — the ability to transfer the investor's interest in the fund to preapproved parties;
- Clawback guarantees — guarantees by the fund sponsor of clawback obligations to the extent the fund overdistributes amounts to the sponsor; and
- Information rights — additional information rights, reports or personal meeting rights.

What are the fund terms?

In the past, real estate funds were mostly closed-end structures, but that changed recently. More often real estate funds are using open-ended structures.

Closed-End Funds

Some of the key characteristics of a closed-end fund are as follows.

These funds are typically structured in a similar manner as private equity funds. They have a limited period of active fundraising (generally 12 months), a fixed investment period in which the fund can make investments, and a fixed-term until the fund is liquidated and gains are distributed.

Closed-end funds have no ongoing subscription or redemption rights for investors (e.g., no investor liquidity), and investors receive periodic distributions of operating cash flow and returns of capital only when assets are refinanced or liquidated.

Open-Ended Funds

Some key characteristics of an open-ended fund are as follows.

These funds are structured similarly to hedge funds. Open-ended funds have a perpetual or longer-term fundraising period, an indefinite fund term and no fixed investment period, giving the fund flexibility to acquire or dispose of investments according to market conditions.

Investors often do not receive current distributions and instead receive returns upon redemption of their interest or when the fund liquidates with returns based on the current market value of real estate assets.

There is also more liquidity for investors because open-ended funds are evergreen. These funds accept investor subscriptions and process redemptions on an ongoing basis so investment capital is not locked up for many years. Evergreen terms are more difficult for fund managers because they have to manage liquidity.

Finally, the fund manager is obliged to make periodic net asset value calculations of illiquid assets through appraisals. This must be done both for periodic statements of value and for fund redemptions.

Term of the Fund

Although real estate funds differ in how they operate, typical industry investment terms for a closed-end fund include an initial closing of subscriptions from investors followed by subsequent closings for additional investors over an offering period of 12 to 18 months.

This is followed by an investment period for finding and acquiring investments of approximately two to three years and a harvest period for improving, managing and selling fund assets of approximately two to three years. This results in a total fund term that is typically seven to 10 years.

Conclusion

This has been a basic walkthrough of some of the considerations to think about before starting a real estate fund. Note that there are numerous federal and state regulatory schemes that may be implicated by the fund that you form, including securities, tax and Employee Retirement Income Security Act regulations.

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