

Considerations for Starting a Real Estate Fund

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As real estate funds continue to succeed and become more prevalent in the alternative investment industry, and with more institutional investors increasing allocations to real estate, more aspiring portfolio managers are joining the race to launch their own real estate funds. While today there are many successful and large real estate funds, the majority of the firms in this space are small to midsize organizations with employees ranging from just a few to several hundred.

For many successful real estate investors and syndicators with several single-asset deals under their belt, the logical next step is to start a real estate fund. Funds offer several significant benefits, including:

- A ready source of equity, allowing you to act quickly as opportunities arise;
- Considerable discretion over investments of the fund's capital;
- Access to larger projects;
- A vehicle for diversifying your portfolio and sharing risks with outside investors/limited partners;
- The potential to negotiate more favorable terms from banks and other lenders; and
- The ability to earn substantial fees on top of any returns on your investment in the fund.

Sponsoring a real estate fund can be highly rewarding, both financially and personally, but it's also a costly and complex undertaking. Before you embark on this journey, be sure that you're prepared and that the timing is right. The following summarizes several steps that managers should follow to launch a private equity fund.

Define Your Business Strategy

When doing single-asset syndicated deals, you may have had a specific investment focus, or you may have been indifferent to the asset class. Starting a fund, however, typically demands a disciplined investment strategy that focuses on a single asset class or a geographic area from which your investment strategy can't deviate. You and your prospective investors will need to evaluate how well your track record aligns with the fund's narrower investment strategy.

Outline Your Historical Performance Record

Potential investors will want to understand your relevant historical performance record before considering making an investment. Managers looking to raise capital often find a lack of a documented track record of past performance to be a roadblock. To alleviate investors' reluctance, you can prepare a summary of your historical performance, including denoting such performance in marketing

materials.

More sophisticated investors will, however, look for the performance record to be accompanied by an independent accountant's report. Meet with your accounting firm to understand the most cost-effective options.

Setting Up Your Fund Structure

Real estate funds are generally structured as limited partnerships or limited liability companies. As a founder of the fund, you will be a general partner or managing member empowered with the right to decide the investments that make up the fund portfolio. Your investors will be limited partners who will not have the right to make any decisions on behalf of your fund or fund investments. One critical decision is whether the fund will be open- or closed-end. An open-end structure allows you to raise additional capital periodically and is attractive to investors, who can redeem their investments or make additional capital contributions over the life of the fund. Given the illiquid nature of real estate investments, however, funds are usually closed end, which prohibits withdrawals or additional contributions over a fixed term (typically seven to 10 years).

Raising Capital

You'll need to raise enough capital to ensure that the fund can cover start-up expenses and ongoing administrative/professional costs while generating acceptable returns for you and your investors. Although there is no minimum amount of capital required to start a fund, as a rule of thumb, a minimum of \$15-25 million of capital is needed. Potential investors will also want to see a "meaningful" contribution from the fund manager (or fund management group) to better align their interests. Based on our experience and industry standards, fund managers have generally provided at least 1% to 3% of the fund's total capital commitments, or have contributed an existing asset to the fund, generally at a discount to the fair value to entice investors.

You'll also need sufficient funds of your own to carry the start-up expenses, which can be significant, during the fund's formation period. Start-up costs include marketing costs to capture and present your investment strategy, historical returns

and your experience; attorney fees to draft legal documents, and accounting fees to assist you with tax structuring. In marketing your fund, it's important to articulate the fund's vision clearly and ensure that investors' interests are aligned with that vision.

Contact your current investors and ask for a soft commitment, making sure they understand how investing in a fund is different than a direct, single-asset syndicated investment. For example, they won't have a say on the specific properties the fund invests in and they will participate in *all* of the fund's investments.

If you need new investors, one option is institutional investors, such as pension funds or other large funds that have allocated capital to other emerging managers but be aware that, depending on the extent of your experience, your "anchor" institutional investor may demand additional economic interests in the fund or the general partner. Another option is to market your offering or "generally solicit" funds from the public. Understand, however, that this approach raises securities law issues that will likely limit participation to "accredited" investors who meet certain net worth and income thresholds, a potential obstacle to investments by friends and family. In 2020, the Securities and Exchange Commission did amend the long-standing definition of an accredited investor, broadening the categories of individuals and entities that meet this definition.

At some point, while raising capital for your fund, you will most likely be asked by one or more potential investors to enter into a side letter. A side letter is an agreement between the fund and an investor to vary the terms of the limited partnership agreement for that particular investor. Some of the most common side letter requests from investors are to take profits-interest ownership in the general partnership to participate in future fees, for a partial or complete waiver of the fund's fees (management fee, carried interest, or both), to reduce the lock-up requirements (which would give them the right to withdraw capital at an earlier date than other investors) and "most favored nation" clauses (which would, in essence, give that investor the right to obtain any benefit granted to other investors via a side letter). Tread lightly and carefully when assessing each side letter request from potential investors and seek legal assistance in drafting and negotiating such agreements.

If any of the investors are foreign, various compliance issues will need to be considered.

Outline Your Current Pipeline of Deals

You'll need a steady deal flow to ensure that the fund can deploy all of the raised capital and earn a return. As discussed above, starting a fund typically requires \$15-25 million of equity, which, with the use of leverage, means approximately \$60-100 million in assets under management. Depending on your average deal size, the number of assets to be acquired may vary.

Fund Expenses, Fees and Distribution Waterfall

One of the most important questions to address when forming your real estate fund is to understand the fees that will be borne by the management company and the fund, and to set the fees that will be charged to your investors by the fund. Well thought out and sound real estate fund offering documents contain terms that look to protect the fund manager and that are amenable to potential investors. Accordingly, the following will focus on real estate fund industry best practices regarding fund expenses, fee terms, and distribution waterfalls.

- **Fund Expenses** - Expenses such as legal, fund administration, tax preparation, and audit fees are generally the costs to set up and run a real estate fund. The fund generally bears expenses directly related to forming and operating the fund. Overhead expenses are typically the responsibility of the fund manager. Your fund documents should clearly state which expenses will be borne by the fund and its investors and which by the fund manager. Quite often an expense cap is placed on the number of expenses that can be charged to the fund, with the excess to be paid by the fund manager.
- **Management Fees** - Real estate fund managers generally charge their investors an annual management fee as well as an incentive fee (also known as performance fee or carried interest). Management fees typically range from 1.5% to 2.00% and are charged either on committed or contributed capital. Incentive fees (also known as carried interest or promote) range widely and represent an allocation of appreciation of assets or net profits by the fund. However, in order for the fund manager to begin receiving carried

interest, the fund must first achieve a stated hurdle rate (also known as the preferred return).

- **Incentive Fees** - Once the fund's administrative expenses have been covered, there are many ways to allocate the fund's profits, including a carried interest allocated to you. A carried interest is a disproportionate share of the fund's profits above a predetermined return threshold allocated to the fund manager. The most common ways to allocate the carried interest are:

1. The ***European waterfall*** is where the carried interest is calculated at the fund level across all portfolio company deals. In this scenario, the fund manager does not begin to take any carried interest until the fund has returned all limited partner contributions across all portfolio company deals as well as having delivered the preferred return.
2. The ***American waterfall*** is calculated on a deal-by-deal basis whereby the fund manager is compensated for each successful deal. This allows the fund manager to begin taking carried interest earlier in the life of the fund, but can also result in the fund manager receiving carried interest on a fund that is underperforming its preferred return (or hurdle rate), as long as there are individual portfolio company deals that have outperformed the preferred return. For funds that use the American waterfall, a clawback provision is needed and should be included in the fund offering documents. Such a provision allows investors to recoup the carried interest at the end of the fund's life if the fund underperformed in total and the fund manager collected more than its share of the overall fund's net profits.

- **Distribution Waterfall** - Defines the economic allocation of the incentive fee. There are four primary components to a distribution waterfall, although the catch-up provision is not always present, and the return of capital and the preferred interest provisions are sometimes reversed:

1. **Return of Capital** - All distributions go to the fund investors until they have received back their fully-committed capital contributed to the fund.

2. **Preferred Return** - Fund investors will continue to receive all distributions until the fund has achieved its preferred return (or hurdle rate). These percentages can range from 6% to 12% of the investor's contributed capital, are compounded annually, and are generally defined in the fund's offering documents.
3. **Catch-up Provision** - Once the fund has returned all capital to its investors as well as the preferred return, the fund manager (general partner) is then able to start collecting carried interest. This is generally calculated by going back to the first dollar of net profits of the fund and allows the fund manager to retain most of the fund's future profits until it has received its stated share of cumulative distributions, with a 20% catch-up hurdle being a common percentage.
4. **Remaining Distributions** - After the fund manager has received its carried interest for fund returns beyond the preferred return, and the catch-up provisions have been satisfied, all remaining distributions are then allocated between the limited partners and the fund manager at the rate specified in the fund offering documents. For example, if the first hurdle is 12%, any profits above this hurdle rate would be allocated 80% to the limited partners and 20% to the fund manager.

Audits and Taxes

You will need to engage an accounting firm to perform an annual audit of your fund and to prepare the fund's tax returns (including Schedule K-1s that you will need to provide to your fund's investors). It is prudent to meet with a firm like Anchin that is experienced with start-up real estate funds before you finalize your legal documents so that you can discuss and better understand the tax issues involved with your particular fund strategy, fund investors and investments. These include reviewing fund and related entity structures, identifying requisite Federal and state tax filings, potential issues related to foreign investors, foreign investments, retirement plans, beneficial tax elections, your plan for manager and employee compensation, and the overall tax impact of running your fund. Preferably, you should look to hire a firm to partner with that not only covers the basics for your accounting needs but is also

capable of helping as you grow your fund. The firm should be actively working with you to minimize tax exposure and to consult and advise on your operations. Look for a firm with a strong reputation of working with emerging managers, as larger accounting firms may not be initially focused on your start-up needs. A coordinated and experienced audit and tax team focused on your business and personal needs are what you will need as you launch your new fund.

The Right Team

Once a business plan has been completed, you should begin to meet with external service providers and consultants, such as accountants, attorneys, and other industry specialists, who can assist you with effectively and efficiently refining and executing your business plan.

The fund manager must decide on the roles and titles of the firm's leaders, such as the role of partner or portfolio manager as well as the establishment of a management team, including the CEO, CFO, CIO, and CCO. At launch, however, it may be wise to outsource some of these functions to allow you time to execute your business plan while keeping costs in check.

It's critical to have a team of experienced advisors and service providers who understand the real estate industry and real estate funds in particular.

Such advisors and service providers include:

- A law firm to advise you on a variety of organizational and compliance issues and to draft the private placement memorandum and other offering materials.
- An accounting firm to assist you with documenting your performance record and preparing audited financial statements, advise you on a variety of financial and accounting issues, and identify the right tax structure for the fund, which can have a significant impact on returns.
- A fund administrator to assist with accounting, investor relations and, communications.
- A property manager (unless you have your own management company).

In Conclusion

These are just a few of the many issues to consider in determining whether you are ready to start a real estate fund. Perhaps most important, you need to be realistic about the significant investment of time and energy — not to mention seed capital — necessary to get a fund off the ground and oversee its operations. It also requires partnering with experienced professionals and a tremendous effort to refine your business strategy, develop your business plan and build your team. The above steps can be used as a roadmap for establishing a successful fund. For more information about what is involved in launching and operating a real estate fund and how Anchin's Emerging Manager Platform can assist, please [contact us](#).