Private Real Estate Funds

What They Are, How They Work
There are various types of private real estate funds.
Understanding the basic structure can help mitigate against associated risks.

The information contained in this white paper does not constitute legal advice.
West Group Advisors has advised many clients over the years on various private equity transactions. We have reviewed scores of third party private offerings and advised clients on various aspects of these transactions. Most share similar features. While private equity covers a much larger universe than just real estate, this white paper explains the typical costs and features associated with investments in private real estate funds.

**What is real estate private equity?**

Private real estate, sometimes referred to as real estate private equity, is a specialized type of private equity fund which focuses on investments in the real estate market. Real estate private equity funds serve to pool investor capital to make debt and equity investments in various types of real estate.

Investors in private real estate generally seek to earn a return on their investment through some type of liquidity event related to the properties owned by the fund. A liquidity event could include:

- a recapitalization of the partnership;
- a direct sale of the partnership;
- a direct sale of an individual portfolio property;
- a merger of the partnership with another company, or
- an initial public offering (IPO) of a private partnership’s shares into a newly formed publicly traded partnership.

Private real estate investing strategies include debt and equity interests in various types of real property. Investment strategies can vary widely and can include new development, redevelopment, or repositioning of properties. Strategies are often diversified across various types of properties and geographic locations.

**Fund structure**

An investment in a real estate fund represents an ownership interest in a limited partnership. The limited partnership in turn owns private companies that are established by the fund manager to hold real properties. Each of the private companies held by the investment fund generally holds one piece of real property in a single asset entity – most often a limited liability company. All of the properties held by the investment fund are referred to as the fund’s portfolio. Real estate private equity funds are typically created by a fund manager, or general partner, who bears responsibility for raising investor capital, administering the fund, and ultimately making and managing fund investments. Investors in real estate private equity funds are referred to as limited partners and typically do not bear any responsibility for the operation of the fund. While
structures vary and can be very complicated, illustrated below is a standard partnership structure.

**Fund ownership**

As mentioned above, private real estate funds, in contrast to publicly-traded entities such as REITs, are not traded on exchanges and are usually not available to the public. Investments in private real estate funds, however, are available to institutional investors and high net worth individuals often referred to as “accredited investors”.

**Fund life spans**

Private real estate funds typically have a seven- to ten-year life span. During the initial two- to three-year period properties are acquired or developed. This is followed by a holding period during which the properties are actively managed and eventually sold.

**Capital commitments and capital calls**

In a private real estate fund, the fund’s managers will raise capital from a number of institutional and/or high net worth individual investors. An investor’s agreement to provide capital to the fund is referred to as a capital commitment. Investors will provide capital to the fund in various installments, as needed by fund managers. When fund managers identify investment opportunities they will issue a capital call, obligating the limited partners to provide the requested funds. The fund’s offering documents will specify the contractual obligations around capital calls and the potential repercussions for failure to meet capital calls. For example, failure to meet a
capital call may result in an investor forfeiting ownership interest in the fund. In some cases, other investors may have the opportunity to acquire the forfeited interest.

**Closed-end funds**

Private real estate funds generally use a closed-end fund structure, which means that, after the fundraising stages (“closings”), the fund is closed to new investors. If a fund does not receive a minimum level of capital commitments it will not launch.

**Capital distributions**

Over the life of the fund, the investments in portfolio properties may create a realized profit to the fund if the properties begin to generate positive cash flow, are sold or recapitalized. The fund will typically distribute the profits to the partners through a capital distribution. This is how investors earn a return on their investment in the fund.

In some cases, fund managers will elect to withhold capital distributions in order to reduce the amount of future funding required from partners. In this way, if the fund’s investors have not fully funded the partnership up to their committed amounts, the withheld capital will be applied to future commitments.

**Private real estate investment strategies**

Private real estate funds generally use one of the following three investment strategies: Core-Plus, Value-Added or Opportunistic.

**Core-Plus.** This strategy is characterized by investments in higher quality properties with a stable tenant base, minimal required improvements, and modest expectations for appreciation. Minimal levels of leverage are used and a significant portion of the total return is derived from income. This is generally considered the most conservative strategy and as such is characterized by lower risk and lower return potential.

**Value-Added.** A value-added strategy involves acquiring properties, making improvements and selling for a gain. The improvements under a value-added strategy can include solving management or operational problems, making physical improvements or solving capital constraints. This is a moderate-risk, medium-return strategy.

**Opportunistic.** Under an opportunistic strategy, the fund will target properties which require a high degree of improvement and can include investments in development, raw land and niche property sectors. This strategy can also target emerging markets, distressed portfolios and non-performing loans. This is considered the most aggressive strategy, and as such has a high-risk, high-return potential.
Terminology and Features

Management Fees. Private real estate funds typically charge annual management fees which are assessed on the value of the investment. The fee will vary depending on the type of fund but generally will be in the 1% to 2% range.

Carried Interest. Private real estate funds typically use incentive-based compensation, often referred to as “carry”, “carried interest” or “promote” (a share of any profits that the general partners receive as compensation), as inducement for managers to achieve annual net cash returns. The fee is a percentage of the fund profits above a certain rate of return to investors.

Distributions. A private real estate fund’s success depends on the ability of its portfolio to increase in value after a period of time (usually several years) and the fund’s ability to dispose or refinance its holdings. The fund’s management often adds to this process by playing an active role in the properties, such as assisting the properties in achieving operating efficiencies, rehabilitation, or stabilization. Afterward, if a portfolio property increases in value, the private real estate fund may seek to dispose of its investment, usually through the sale of the property to a third party buyer or in a public offering of the fund through the sale of company stock. The proceeds of these sales are generally distributed to the private real estate fund’s investors pursuant to the fund’s established distribution structure.

Investor Preferences. Investor preferences are sometimes given to the investors in the fund before distribution splits are calculated. It specifies, for example, that an investor will receive his or her initial investment plus a preferred return before the general partners can participate in the profits. Such an arrangement can increase the investor’s confidence in the fund and its potential profitability for them.

Distribution Waterfall. A waterfall is the order in which a private fund makes distributions. In other words, it is a hierarchy delineating the order in which funds will be distributed, and may ensure that different types of investors have priority of payment compared to others within the same fund.

Clawback. A clawback refers to money or benefits that are distributed and then taken back as a result of special circumstances.

Use of leverage. Private real estate fund managers can structure the debt of their portfolio properties in order to expand net profits and create increased investor value. Funds may utilize a range of property-specific borrowing options from senior secured debt to high-yield debt.

If leverage is assumed at the individual property level, rather than by the fund itself, a fund manager can effectively safeguard each property from the default risk of the other properties in the
portfolio. As a result, investors may experience the enhanced returns of a leveraged portfolio with less risk than would be experienced if leveraged at the fund level.

While private real estate funds may employ leverage as a means to enhance returns, leverage is typically not the exclusive investment strategy. Leverage is often used as it can increase buying power while amplifying returns. However, leverage also increases risk and can magnify negative returns in situations where investments are poorly structured or executed, or if market conditions deteriorate. Leverage should be employed responsibly on an investment that meets fundamental investment criteria before adding debt.

**Investor characteristics**

**Suitability.** Private real estate funds are not appropriate for all investors. In order to invest in a private real estate fund, prospective investors are required to meet minimum financial eligibility guidelines. Potential investors should evaluate their individual financial condition and ability to tolerate risk before investing in these funds. In particular, investors should fully understand the risks associated with the investment and be capable of tolerating the potential loss of their entire investment.

**Accredited Investors.** Private real estate funds are not registered with the U.S. Security and Exchange Commission (SEC), therefore, they can only offer or sell securities to certain types of individuals which are known as “accredited” investors. Accredited investors are defined as an individual with at least $1 million in individual or joint net worth (exclusive of the value of the primary residence) or individual annual income of at least $200,000. Also included are couples with combined annual income of at least $300,000 for the past two calendar years, with the reasonable expectation that the income will continue in the current calendar year. Accredited institutional investors are defined as someone who has at least $5 million in investable assets.

**Qualified Purchaser.** Some fund offerings may require investors to meet SEC guidelines of a “qualified purchaser”. These guidelines require that individual investors have at least $5 million in investable net worth in order to be eligible to invest in private real estate fund. Institutions are required to have least $25 million in investable assets.

For certain offshore private real estate funds and other unregistered funds, the financial eligibility requirements may be lower than those listed above.

**Risks to investing in private real estate**

**Long-term investment.** Investments in private real estate funds are generally less liquid than other investments. In many cases, underlying investments may not be easily sold or may be under development. As such, private real estate funds are considered long-term investments which
generally span seven- to ten-years. Funds typically have limited provisions for redemptions. Prospective investors should consider the financial capability to bear large fluctuations in value and hold these investments over a number of years.

**Lack of liquidity.** Ownership interests private real estate funds cannot be sold or exchanged easily and, in many cases, the interests cannot be transferred without the approval of the fund manager. As a result, private real estate funds are generally only appropriate for sophisticated investors who have carefully measured their financial capacity to hold these investments for a long term period.

**Capital calls.** Capital calls are a contractual obligation of the investor. Failure to meet capital calls could result in significant negative consequences, which could include the forfeiture of the investor’s interest in the fund.

**Leverage.** Private real estate funds may use debt to acquire properties or may invest in ventures employing significant leverage. Leverage involves a high degree of financial risk and increases exposure to rising interest rates and deterioration in economic and market conditions.

**Manager risk.** Private real estate fund managers typically have complete authority over investments made by their funds. Investors will receive reports from the fund manager, but will have no control or influence over investment decisions or management of the fund.

**Tax treatment.** Investors in private real estate funds are generally subject to tax on income and/or capital gains distributed to them from those funds. Investors’ tax liabilities may exceed distributions received from the funds in any particular year. Investors may also be subject to limitations on their allowable share of deductions and losses related to the fund. In the case of retirement accounts such as IRAs, private real estate funds may generate unrelated business income tax (UBIT) or unrelated debt income tax (UDIT). Investors should consult with their tax advisors before making an investment.

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