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Real estate funds: a primer for investors and fund sponsors

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This article introduces certain key concepts that arise when working with real estate funds. The article begins with a comparative analysis on the general differences between a closed-ended fund and an open-ended fund, and goes on to discuss more specific fund-related concepts and how they apply in the context of real estate funds.

Open-ended vs. closed-ended structure

One of the primary considerations for sponsors when forming a real estate fund is whether to opt for a closed-ended or open-ended structure.

Differences between open-ended and closed-ended funds

There are several important differences between open-ended and closed-ended funds, and these differences inform sponsors' decisions when forming real estate funds.

An open-ended fund does not have a fixed term and so continues in perpetuity unless actively terminated (it is therefore also known as an "evergreen fund"). In contrast, a closed-ended fund has a fixed term (usually in the range of 8-10 years).

The two structures also differ when it comes to capital. Unlike closed-ended funds, which have a defined time period to raise, invest, harvest and distribute capital, open-ended funds can continuously raise, invest, harvest and distribute capital for as long as the fund is in operation. And unlike in closed-ended funds, where LPs are generally locked in for the duration of the term, open-ended funds offer LPs the ability to redeem their interests on a periodic basis, subject to certain restrictions in the fund's governing documents including lock-up periods.

How to decide between open-ended and closed-ended funds

Open-ended funds have certain advantages and disadvantages over closed-ended funds. They are less impacted by prevailing market conditions, due to their ability to hold on to their investments on a longer term basis until such time as the GP believes is most conducive to optimizing returns. In addition, open-ended funds, at least in theory, can manage a more diversified portfolio of assets compared to closed-ended funds given their indefinite lifespan.

At the same time, LPs investing in an open-ended fund may find it difficult to forecast when they will realize returns given the potentially indefinite maturity period. From the GP's perspective, open-ended funds are also generally more difficult and costly to administer given their longer duration, a larger and more diversified portfolio, as well as the administrative burden associated with the active monitoring of the periodic inflow and outflow of LPs, dealing with redemption requests of investors, and ensuring that “most favoured nation” clauses in investors’ side letters are respected.

Warehousing and transfer of real property assets

Fund sponsors may decide to “warehouse” an investment, whereby they would transfer an existing asset from their own balance sheet into the fund prior to raising capital from investors. Warehousing an investment can be beneficial to GPs from a marketing perspective, as it increases the fund’s assets under management from the outset and demonstrates to the investors the GP’s prior track record. In addition, warehoused investments can provide investors with a primer on the GP’s investment strategy, and also demonstrate a degree of alignment from the GP.

In the context of open-ended funds, where management fees are often charged based on invested capital or net asset value (commonly referred to as “NAV”)—as opposed to capital commitments, which are customarily the fee base for closed-ended funds—GPs may also choose to warehouse an investment in order to kickstart the accrual of management fees. Some GPs even choose to stagger the “rolling in” of warehoused assets in order to (i) keep the management fee base low (to avoid turning off potential investors) and (ii) account for any projected fluctuations in such assets’ value.

With real estate funds, warehoused investments often take the form of real property assets that may or may not involve a debt component. If the asset to be warehoused is backed by debt, sponsors should carefully review the underlying credit agreement for provisions that may prohibit or otherwise undermine the proposed warehousing transaction, including any restrictions on transfers or a requirement to obtain the lender’s consent. On the other hand, investors looking to commit capital to a real estate fund with warehoused assets should carefully diligence the debt-to-asset ratio of such assets. In connection with the transfer of real estate warehoused investments, these assets are often transferred to the fund on a tax-deferred basis using rollover mechanisms. Other considerations in connection with warehoused investments relate to valuation, cost base and future return mechanics.

Capital commitment

Funds are capitalized by capital commitments from investors in exchange for interests in the fund. Oftentimes, no money is exchanged between the investors and the GP upon the GP’s acceptance of the investors’ capital commitments. Rather the investors would enter into an agreement with the GP that authorizes the GP to periodically call capital from the investors throughout the fund’s term, up to their capital commitment amounts, for purposes of making investments, paying the fund’s expenses, repaying any borrowing incurred by the fund or paying management fees.

In some instances, fund sponsors may commit their own capital to the fund in order to demonstrate alignment with their investors, and sophisticated investors often will require this alignment by ensuring that it is a condition of the fund documentation that the sponsor maintains a minimum equity contribution in the fund.

In the context of a real estate fund, capital commitments may also take the form of real estate assets. In such cases, the capital commitment will be deemed to have been “fully contributed” upon consummation of the transfer of the assets. A capital commitment in the form of real estate assets involves certain bespoke considerations such as valuation (which is particularly important for development properties, which are generally expected to appreciate in value over time), the settlement of any debt associated with such assets, as well as how to structure the payment of fund expenses and management fees (which are customarily paid pursuant to periodic capital calls).

Land transfer tax

Real estate funds need to carefully monitor exposure to land transfer taxes, which may vary depending on the jurisdiction(s) in which the fund operates. Certain provinces, including Ontario, generally apply land transfer tax on the basis that each limited partner of the fund indirectly owns its pro rata share of the underlying real property owned by the fund.

Accordingly, if an investor subscribes for interests in a fund that already owns real property, the investor may become subject to land transfer tax liability in respect of that property and at any time the limited partner increases its limited partnership interest unless an exemption is available to the investor. In the context of an open-ended fund, where an investor decides to redeem its interests and the remaining LPs' proportionate share of the fund (and of its underlying assets) is increased as a consequence, the remaining limited partners may become subject to land transfer tax in respect of such increase.

Nature of underlying asset

For sponsors that are considering forming a real estate fund, the nature of the assets the fund will invest in is an important consideration in determining whether to opt for a closed-ended or open-ended fund structure.

For instance, if the fund's strategy is to invest in stable, long-term income-producing assets such as mortgage debt instruments or core/core-plus assets, an open-ended fund structure would be more suitable. On the other hand, if the fund's strategy is to invest in more aggressive, high-yield developmental properties with shorter growth horizons, a closed-ended structure would be preferable in many respects.

Redemption rights

As previewed above, open-ended funds generally allow their LPs to redeem their interests in the fund on a periodic basis subject to lock-up periods. The ability to redeem is a key protective measure for LPs in open-ended funds, because open-ended funds often do not offer LPs the more traditional remedies that are customarily found in closed-ended funds, such as the right to terminate the fund or the investment period upon the occurrence of certain events, such as the triggering of a key person clause. Instead, investors in open-ended funds are often allowed to "vote with their feet" if they have any issues with the GP, by exercising their redemption right and exiting the fund.

In the context of a real estate fund, where the underlying assets are often highly illiquid, it may be difficult for the GP to generate sufficient cash to satisfy all redemption requests. As a result, the obligation of a GP to satisfy a redemption request is often subject to an efforts standard and other limitations. One example would be an explicit provision in the governing documents that the GP will not be required to sell the fund's assets or take any other actions in order to fulfill redemption requests if doing so would have a material adverse effect on the fund. GPs may also have the ability to suspend redemptions in limited circumstances, including if an accurate valuation of the assets is not possible at the time, during any period of political or economic instability, if transactions cannot be carried out at normal rates of exchange, or if otherwise prohibited by applicable law.

A fund may also employ a "tranched" redemption strategy, whereby redemption requests are satisfied in the order in which they are received, with any unsatisfied requests being carried forward into the next tranche. More aggressive sponsors may subject the entirety of the fund's redemption strategy to the GP's discretion (i.e., redemption requests will be fulfilled at such times and in such amounts as the GP determines appropriate).

Continuation vehicles

Continuation vehicles are becoming increasingly popular in the context of closed-ended funds, as they present a creative solution for GPs who wish to hold on to investments beyond the fund's term. For instance, consider a closed-ended real estate fund that invests primarily in developmental property. If, at the end of the fund's term, the GP determines that the property continues to be an attractive investment (either for its projection for additional growth or for income-generating ability), or if the GP determines that the asset's full growth potential has not been realized yet, the GP may decide to form a continuation vehicle to purchase the investment from the existing fund.

Upon formation of the continuation vehicle, existing LPs would typically be given the choice to either redeem their stake in the investment or continue to participate in the investment by "rolling over" their interests into the continuation vehicle. As such, continuation vehicles serve as a liquidity solution for LPs, which, like other secondaries transactions, is particularly attractive in the current climate of ongoing market volatility and a trend towards lengthening fund terms. Furthermore, continuation vehicles also present opportunities for new investors to participate in the fund's existing investments, and have contributed significantly to the recent growth in activity levels in the secondaries market.

While in theory continuation vehicles are a winning strategy for both sponsors and investors, they also raise practical considerations relating to such things as structuring, valuation, and conflicts of interest, which may increase costs for the GP and turn off investors from participating.

For more information on the secondaries market, please refer to this article on why fund sponsors are increasingly turning to the secondaries market.

Fees

Fund sponsors typically charge LPs a management fee, often payable on a quarterly or semi-annual basis, in the range of 1-2% per annum. In theory, management fees are intended to compensate sponsors for costs incurred in connection with the day-to-day overhead of the fund (although in practice, management fees have essentially become a separate profit stream for sponsors, especially in the context of mega funds). Sponsors also often rely on fee discounts as a means of attracting capital; common examples include discounts granted to early-bird investors and discounts granted to investors with a large capital commitment.

In the case of a closed-ended fund, there would be a step-down in the management fee following the end of the investment period (i.e., the period during which the sponsor is most actively engaged in the management of the fund). By way of example, a fund may charge a 2% fee based on capital commitments during the investment period, and a 1.5% fee based on invested capital following the investment period. In the context of an open-ended fund, where there is no pre-defined investment period, management fees would often be charged based on invested capital from the outset, which means the GP would not earn any fees until the initial drawdown of capital.

Fees specific to real estate funds

In the context of a real estate fund, there are several other types of fees that the sponsor may choose to charge its investors, depending on the fund's strategy and what is market at the time. Below are some common examples of such fees:

- **Acquisition fees** relate to costs incurred in connection with identifying, researching, modeling, underwriting and acquiring portfolio investments.

- **Disposition fees** relate to costs incurred in getting a property ready for sale, including costs of evaluating market conditions and timing for sale.

- **Construction management fees** may be relevant in the context of a real estate fund whose strategy is to generate value by acquiring and developing real estate property, and would include costs related to construction, third-party contractor fees and expenses related to regulatory permits, among others.
- **Property management fees** are typically charged in income-focused funds where the manager of the fund (or an affiliate thereof) is responsible for providing property management services at the underlying properties in exchange for a monthly fee.
- **Origination fees** are fees charged by the lender to the borrower for making a mortgage loan, and may be relevant in the context of a real estate fund whose primary strategy is to invest in mortgages.
- **Servicing fees** may also be relevant in the context of a mortgage fund. These fees would be paid to the mortgage servicer as compensation for collecting, making escrow payments, passing principal and interest payments along to the note holder, as well as maintaining a record of payments related to the mortgage.
- **Leasing fees** may be relevant in the context of a real estate fund that generates income by investing in and leasing out rental property. These fees would include any costs involved with the leasing process, including showcasing the property, screening applicants and finding and approving tenants, among others.

Experienced counsel can be consulted to provide fund sponsors and fund investors an idea of what constitutes the market range of the above-noted fees at any given time.

Side letters and most favoured nation right

Fund sponsors may decide to enter into a side letter with an investor to document certain terms of the investment that should apply specifically to that investor. Provisions included in a side letter may include, but are not limited to, preferential economic terms such as fee or carry discounts, reporting that is supplemental to what is provided for in the fund documents, the right to be excused from certain types of investments, and the general partner’s covenant to operate the fund in a manner consistent with laws and regulations applicable to the particular investor.

A side letter may or may not include a most favoured nation (MFN) right, which, if included, would allow the investor to elect side letter terms granted to other investors with an equal or lower commitment amount than the investor (subject to certain carve-outs that vary from fund to fund).

MFNs for open-ended and closed-ended funds

In the closed-ended fund context, the MFN process would take place following the end of the fundraising period. Investors with sufficient negotiating leverage can generally expect to receive an MFN provision in a closed-ended fund, although there are sponsors that refuse to grant one to any investor as a matter of policy. In the event a fund manager refuses to grant an MFN provision, the investor may wish to request confirmation that every other investor in the fund will similarly not receive an MFN provision or diligence the terms of any economic discounts that are being granted in favour of other investors.

In the open-ended fund context, where the fund can continuously admit new investors and accept additional capital commitments from existing investors, the typical closed-ended fund approach of allowing LPs to make MFN elections at the expiry of the fundraising period is not possible. As such, fund sponsors of open-ended funds should consider how to structure their MFN process based on their LP base, expected frequency of closings, administrative capacity and other factors. Some MFN structuring options include allowing LPs to make MFN elections on a periodic basis (e.g., annually) or limiting MFN elections to only economic/liquidity provisions.

To discuss these issues, please contact the author(s).