Private Equity Investments in Real Estate – A Primer on the Menu of Structures Available

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With increasing frequency, experienced high-wealth individuals and institutional investors (such as banks, pension plans, insurance companies, etc.) are pursuing alternative investments to stocks and bonds to better distribute their overall risk, achieve higher returns, diversify their investment portfolio, and protect against market downturns. According to the Investment Company Fact Book, globally, the total amount of worldwide assets invested by institutional investors in mutual funds and exchange-traded funds in 2014 was $33.4 trillion, which increased to $37.2 trillion in 2015. In fact, allocations to non-traditional investments of stocks and bonds to alternative assets, especially investments into various real estate structures and, to a lesser extent, hedge funds, private equity, and commodities, have grown from 5% in 1995 to approximately 25% in 2015 (as reported by Towers Watson, a global professional services firm for risk management and human resource consulting).

Real Estate Investing—Overview

U.S. real estate investing is possible through a variety of structures. Investors may select direct or indirect exposure to an underlying portfolio of real estate, ranging from one discrete property to a widely held portfolio, and that vary in their investment strategies, transparency, size, minimum investment amounts, management styles, complexity, and associated fee structures. The most basic structure is the single-asset acquisition vehicle, generally known as a direct investment, where an investment vehicle directly owns a single property. From here follows real estate syndications and private-offered real estate funds that are both forms of pooled structures holding multiple real estate assets and are privately-offered, not registered with the Securities and Exchange Commission (SEC), and not listed on any exchange. The most complex structure for investment in U.S. real estate is the Real Estate Investment Trusts (REITs), which are pooled investment vehicles consisting of relatively large numbers of investors, registered with the SEC, either private or publicly traded over a national exchange, and subject to a complex set of tax regulations.

The U.S. real estate market has benefited profoundly from this growing interest in alternative investments, which is only increased when coupled with a mounting instability in emerging foreign markets and recent access to innovative financing channels to source mezzanine capital (i.e., subordinated debt or preferred equity that is senior to developer equity and common shares but junior to senior construction financing). For example, developers' access in recent years to the low-cost debt or equity raised via the U.S. Immigrant Investor Program known as EB-5 and, more recently, crowdfunding through the three newly enacted general solicitation exemptions under the Jumpstart Our Business Startups Act (JOBS Act) of 2012 have grown in popularity. New rules under the JOBS Act led to the launch of new investment structures such as the eREIT, which is a private REIT that raises funds through crowdfunding but is more transparent that a typical private REIT.

More than ever, proper planning for a real estate transaction is imperative to lowering tax expenses and upfront structuring costs to increase returns for investors. To plan effectively, numerous factors warrant consideration before investing in real estate. Chief among these key factors is the ownership structure of the investment vehicle, whether it's a direct investment or a pooled investment vehicle (such as a real estate fund or a REIT). Investors looking to allocate capital into real estate have numerous options that offer a range of economic and tax benefits (as well as risks and return profiles). The following discussion attempts to familiarize the reader with public or private structures utilized by real estate developers and promoters (also called sponsors) to hold property and offer investments therein.

Sponsors typically predict their potential profits in terms of cash-on-cash return or internal rates of return (IRR). A cash-on-cash return is the projected annual return in cash on the investor's investment on a non-compounded basis. On an as-stabilized basis, real estate projects typically project a cash-on-cash return of 7%–12%, depending on the asset sector, the level of risk involved based on the capital stack, experience of the principals, and novelty of the venture, as well as the relative strength of the geographic area where the project is located. In contrast, an IRR incorporates time value of money as well as cash flows, thus investors can measure and appraise a potential investment by virtue of the projected IRR that frequently range even higher—up to 15%–20%—depending on the geography, asset class, risk profile, and so forth. Investors should not make decisions based solely on IRR estimates without digging deeper to ascertain the Sponsor's assumptions used to derive the IRR. Instead, investors should rely on their experience, other project metrics, market research, whether the tax structure accommodates their needs and sometimes, always intuition.

Direct Investments

Direct real estate investing involves purchasing a specific property by acquiring an ownership interest in an entity that directly owns the property. This is known as an equity direct investment; in contrast, a debt direct investment refers to capitalizing a loan that is collateralized by the property. Frequently, equity direct investments involve the acquisition of apartment units, senior communities, shopping centers, or office buildings. Direct investments have less market volatility than a public REIT and none of the high fees associated with a private REIT.

From a structuring standpoint, the simplest structure to acquire income-producing property is a direct investment. The structure utilizes a pass-through vehicle—either a limited liability company or limited partnership that serves as a pass-thru for U.S. tax purposes—and has further advantages of flexibility and low cost to form and operate (as compared to REITs, for example). This investment structure affords investors a stronger negotiating position prior to investing, on account of its simple infrastructure, as well as being uncorrelated to general market fluctuations as it is holding a discrete real estate asset as its entire portfolio. Moreover, direct investments rely principally on a combination of the subject property's market positions and the management decisions, both of which the investor can control in a more direct manner than would otherwise be possible through any indirect investment structure. Direct investments are especially advantageous for investors ready (and capable of) undertaking the level of management that the property requires.

While many investors have success with direct real estate investments, some face certain issues that they otherwise wouldn't through an indirect exposure to the underlying real estate asset. Some of the key challenges investors face with direct investments include:

- Limited access to locating good investment opportunities as a lay investor
- The significant cost involved in acquiring a single real estate asset because the investor would be the sole source of equity
- The requirement to manage the asset after acquisition—which includes repairs, renting, and monitoring the property—would fall to the investor unless these services were contracted out which would reduce profits
- The lack of diversity in the investor's portfolio that comes with a single investment is risky because it fails to tap into several asset classes such as residential, commercial, industrial, and retail properties, nor does it tap into diverse geographic areas
- Increased risk to the investor from the lack of liquidity caused by the ownership of a single asset that is dependent on the economy

However, one of the advantages of direct investing is that the investor has decision-making ability with respect to the underlying property and control in its management and exit strategy.

Real Estate Syndications

By selecting a one-off syndication structure, investors can pool their investments to purchase a specific, identified real estate asset along with other investors and the project sponsor. The sponsor is in charge of finding, financing, acquiring, and

managing the underlying asset. The investors co-invest with the sponsor to own a proportionate share of the asset. Investment returns from real estate syndications generally correlate to those of direct investments. A syndication investment is generally structured to generate enough income to cover costs, debt, and management of the property, while providing targeted investment returns. Investors with limited capital and without the expertise necessary to manage real estate tend to utilize syndications. Compared with a direct investment, there is more overhead on account of the sponsor, but concomitantly no management responsibilities.

Such syndications are privately offered under the U.S. Securities Act of 1933, as amended (the Securities Act), meaning that they are subject to Reg. D that stipulates that such offering generally can only be made to accredited investors. Additionally, until recently, it also meant that a sponsor could not engage in a general solicitation with respect to such offering. However, this has recently changed; in September 2013, the SEC released final rules pursuant to the JOBS Act for a new offering exemption (Rule 506(c)) authorizing general solicitation (Rel. 33-9415) and permitting general solicitation efforts, provided that the issuer uses reasonable methods to verify that each purchaser of the general solicitation is an “accredited investor”. Since the enactment of Rule 506(c), more than 70 real estate crowdfunding sites have launched, making syndications much more accessible to accredited investors than ever before.

Syndications employ a limited liability company or limited partnership structure, each of which provides pass-through tax treatment, limited liability for both the investors and the sponsor, and ease of management, including in creating different classes of securities to accommodate differing investment terms. Syndications generally do not permit withdrawal or redemption during the life of the investment, which varies greatly among syndications (ranging from short-term of 6–12 months to 3–4 years to upwards of 7–10 years or more). Syndications allow investors to invest in larger properties than they otherwise could afford and/or manage. Typically, syndications are income producing, generating monthly or quarterly distributions.

In addition, the sponsors may assess fixed fees, such as:

- A financing fee generally equal to 0.5%–1.5% of any indebtedness
- An acquisition fee generally equal to 1% of the property’s purchase price (though it could range from 0.5%–3%)
- A loan guaranty fee generally equal to 0.5%–2% of any guaranteed indebtedness
- A property management fee generally equal to 3%–5% of gross collected rents
- An asset management fee generally equal to 1%–2% of gross collected rents
- A construction management fee generally equal to 1%–3% of the total cost of all improvements
- A disposition fee (or brokerage fee) generally equal to 1%–3% of sale price of property, although sometimes this is couched as a brokerage fee that can be as high as 5% unless a cooperating broker is involved, in which case the commission is typically split
- A leasing fee at market price based on the type of real estate and the geography of the real estate asset

Most syndications are structured to provide investors with a preferred return. Accordingly, instead of collecting guaranteed fees and delivering a fixed return, many sponsors often reduce fixed fees in exchange for a promote (a percentage of gain received when a certain IRR or hurdle is achieved) that provides the opportunity for a bigger reward or percentage of profits if certain performance levels are achieved. Thus, Sponsors are compensated for generating a higher overall return, a profit that can be shared with investors.

Commingled Funds—Private Real Estate Investment Funds

Real estate funds produce similar benefits for their investors as they would have through a mutual fund in so far as both have professional portfolio management. Real estate funds may invest in underlying real estate assets either directly or indirectly through REITs (either public or private). Many direct real estate funds invest a portion of their income in public mortgage REITs to increase returns and diversify the portfolio. An investor may select a real estate fund that intends to invest in one or more REITs and thereby gain indirect access to REITs thru a direct investment vehicle.

Most real estate funds acquire some combination of office, commercial, and rental properties across a defined geographic area. Investors should make sure that members of the management team have experience with the type of assets that the real estate fund is acquiring. For example, if the fund intends to acquire and operate senior living facilities, it would be best to invest elsewhere if the management team lacks such experience. Many such funds launch as blind pools, meaning that the fund has not acquired or even identified the assets; its offering documents disclose only what type of assets are being sought and in what geographic area. Generally, only the more experienced sponsors are able to successfully raise such blind pools. Regardless of the underlying portfolio, investors need to understand that by investing in the underlying assets through a professionally managed pool, they will have none of the control they otherwise would in a direct investment (or through a syndication model).

Regarding economics, most real estate funds include a preferred return to investors that ranges from 6%–12% of the investor's committed capital. The preferred returns are typically accrued, but not compounded, annually. A sponsor's compensation is both asset- and performance-based. The latter consists of a "carried interest" that is approximately 20% of the fund's net capital appreciation distributed upon the realization of an underlying portfolio investment. The former includes an investment management fee that is assessed annually ranging from 0.5%–2% of committed capital to the fund.

Real Estate Investments Trusts (REITs)

A REIT is similar to a real estate fund in that a fund manager aggregates investors' funds to acquire real estate assets and, like real estate funds, creates a diversified portfolio. Specifically, a REIT is a pass-through corporation formed to own and manage income-producing real estate assets such as mixed-used complexes, office buildings, resorts and hotels, stores and shopping malls, apartments, self-storage centers, warehouses, and assisted living centers. Investors may choose REITs that diversify across asset classes and geography or REITs that specialize in a single asset class but still hold multiple assets to distribute risk. REITs that acquire such commercial properties and lease the space to tenants who pay rent are known as equity REITs. Additionally, REITs can also invest in mortgages that are known as mortgage REITs (hybrid REITs are a combination of these two). While REITs can be either public or private (as herein discussed), both provide their respective investors diversification, regular distributions, and professional management, while simultaneously providing such investors the chance to earn income from investment in commercial real estate who otherwise would not have access to investing directly in the underlying real estate assets.

As REITs provide investors with an efficient entrance to a centrally managed real estate portfolio, REITs are a preferred investment vehicle for those who seek a diversified portfolio of real estate but lack direct investment access and are otherwise unwilling or unable to invest the significant minimum investment amounts that private real estate funds demand. REIT returns are also generally attractive, particularly in a low interest rate environment. To qualify as a REIT, a company must invest the substantial majority (at least 75%) of its assets in real estate or real estate commercial paper and it must annually distribute at least 90% of its taxable income to its shareholders in the form of dividends. REITs' popularity has increased in recent years as investors pursue these investment structures because of the dividend distribution requirements and the diversification among a larger number of assets. Public and private REITs enjoy pass-through status and are taxed identically by the Internal Revenue Code under 26 U.S. Code § 857 et seq.

Private vs. Public REITs

REITs can be either publicly traded or private (i.e., not registered with the SEC and sold to "accredited investors" only, as defined in Reg. D of the Securities Act). Private REITs generally have a higher yield than public REITs, but have lower liquidity because of the lack of a public market, while their fees are generally higher. On the other hand, public REITs have greater fluctuation of their unit prices than private REITs.

Private REITs

A private REIT's lower volatility, and thus its apparent stability, is attributable to the underlying source of its per-unit valuation, as such valuations are tied to the appraised value of the underlying assets of the REIT. Accordingly, the unit price of a private REIT does not correlate with fluctuations in the equity markets, making private REITs more consistent than public REITs with one of real estate investment's fundamental goals—to offer investors a hedge against the fluctuation of the stock markets.

When investors desire to liquidate all or a portion of their private REIT units, the private REIT determines the aggregate net asset value (NAV) of all of the assets and also the investor's proportion share, much like a private real estate fund. Non-traded REITs are required to revalue their shares 18 months after the close of the offering and at least every 18 months thereafter. A private REIT offering closes when it is no longer publicly offering units either through the initial offering, extension, or through a follow-on offering (i.e., an issuance of stock after an initial public offering).

Typically, investors in a private REIT may derive income and returns from periodic distributions of REIT taxable income declared monthly, quarterly, or otherwise during the course of the investment. In addition, investors expect to receive an increase in share price at either the time of liquidation or listing on a national stock exchange or increase in value of portfolio assets upon sale. Typically, private REITs' exit strategy is one of the following: (i) list its shares on a national stock exchange to allow investors the ability and the choice to sell their shares on it; (ii) sell its portfolio of assets to an institutional or other buyer, with its stockholders receiving a pro-rata share of any net proceeds; and (iii) sell individual assets, and stockholders may receive a pro-rata share through distributions of any net proceeds upon the sale of each asset. While private REITs offer insulation from the volatility of the public markets, most private REITs face high fees of 12%–15% and a lack of transparency, which investors should keep in mind during their due diligence.

Investors may find appealing instead a hybrid of the traditional private REIT, which is the eREIT that utilizes crowdfunding to raise funds under Regulation A of the Securities Act. The eREITs to date have lower formation and offering costs that increase returns to investors. Further, the eREITs increase the amount of transparency vis-à-vis the private REITs because of the SEC filings required.

Public REITs

Public REITs have significantly more transparency as they must register with the SEC and remain subject to the SEC's regulations as well as the rules of the exchange on which it publicly-trades its shares. For example, stock exchange rules require a majority of directors to be independent of management, and rules of the New York Stock Exchange and NASDAQ require independent committees to oversee audit, nomination, and compensation.

A public REIT's primary goal is to provide income to its investors and increase share price while preserving investors' capital, yet still providing investors with attractive and stable cash distributions. Because a public REIT can have a significant number of investors, it has the pooled purchasing influence to purchase institutional-class real estate assets not otherwise available to individual investors. When a REIT's portfolio of real estate assets becomes an exchange-traded security, the public REIT's market value may no longer correlate to the value of the real estate assets and it may cease behaving like a real estate investment and start to act more like an exchange-traded stock. On the other hand, this means that investors in a public REIT have greater liquidity than their private counterparts as they purchase and sell their shares similar to traditional stock traded on an exchange.

Other Considerations when Choosing a Structure

U.S. vs. Non-U.S. Investors

While the various structures discussed above may differ in complexity and size, income from each are taxed very similarly for U.S. tax purposes, especially with respect to U.S. investors. With respect to non-U.S. investors, the tax analysis becomes at once more complex. If the investment vehicle is marketing to non-U.S. investors, the structure will need to take into considerationthe U.S. Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).

FIRPTA adds an additional tax to non-U.S. investors' income from U.S. real estate assets (including income received from real estate through a real estate fund or distributed from another entity). This tax is secured by withholding a portion of the income (see Protecting American Taxpayers from Tax Hikes (PATH) Act (H.R. 2029, P.L. 114-113), enacted in December 2015), which included an increase in the FIRPTA withholding rate from 10% to 15%. Before the PATH Act's amendments, FIRPTA included exemptions with respect to 5%-and-smaller positions in publicly traded real property holding companies, and stock in domestically controlled REITs (i.e., a REIT whose equity, by value, was owned 51% or more by U.S. persons). The Path Act increased the percentage from 5% to 10% of publicly traded stock that a non-U.S. investor may hold in a public REIT without disrupting the exemption from FIRPTA on the sale of the stock or the distributions from the public REIT. The Path Act added

an exemption from FIRPTA for certain treaty-eligible publicly traded entities that invest in REITs (public or private REITs) even if the 10% limitation is exceeded subject to some exceptions.

In addition, FIRPTA imposes additional obligations on non-U.S. investors, such as to the requirement to file U.S. tax returns (which many non-U.S. investors do not) and, thusly become subject to IRS scrutiny on their worldwide income. The use of a blocker entity, such as a leveraged blocker, can effectively structure around FIRPTA issues and succeed in ameliorating or eliminating altogether the FIRPTA tax. A leveraged blocker will protect non-U.S. investors from the U.S. tax filing requirement imposed by FIRPTA and lower the effective rate of U.S. tax that non-U.S. investors will shoulder on their investment. A leveraged blocker is typically a corporation that is capitalized with loans and equity from its investors. The investors capitalize the blocker corporation and the blocker corporation makes the investment in the real estate structure. Consequently, the blocker corporation is responsible for the U.S. federal and state tax filings and related income taxes thus sparing the non-U.S. person.

The distributions to the non-U.S. person from the blocker corporation are treated as a dividend and thus not subject to FIRPTA. On the other hand, the blocker structure creates tax at the U.S. corporate level and at the investor level via withholdings on the dividends. However, the tax rates on dividends to shareholders frequently are lessened by treaty while REIT dividends may be taxed at a higher tax rate under the identical treaty. The blocker corporation can lessen its corporate-level tax cost by having investors fund their investment with debt so the corporation receives an interest expense deduction. Thus, the leveraged blocker is more common than a simple blocker structure. Plus, the interest income is taxed more advantageously either under an exemption for portfolio interest or through a reduced treaty rate.

While co-investing with non-U.S. persons in U.S. real estate is complicated, non-U.S. investors' importance as a capital source for investment into U.S. real estate has grown significantly. Thus, accommodating non-U.S. investors and clearing a path for their continued investment into the United States is key.

Conclusion

In this practice note, we explored the variety of investment structures that investors may choose when considering investment in U.S. real estate. The foregoing structures are the most common, and any different structure offered would likely be a minor variation of these presented. Investors should investigate an investment's costs, transparency, tax treatment, and investment objective carefully, and choose one that is managed by real estate professionals with the expertise necessary to assemble diversified portfolios of the best real estate investments available and manage such investments to realization.