



Funds in Focus 2019

Private Funds Annual Review Conference

Real Estate Funds and REITs

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Proskauder»

What are Real Estate Funds?

- Collective investment vehicles through which investors participate in the acquisition/origination, construction, (re)development, operation and appreciation of real estate-related assets.
- Fund offerings are exempt from registration under the Securities Act of 1933.
- Funds are exempt from registration as investment companies under the Investment Company Act of 1940.

RE Fund Structures

- Closed-Ended
- Open-Ended
- Hybrid
- Permanent Capital
- Programmatic JVs

RE Fund Strategies

- Core
- Core+
- Value-Add
- Opportunistic
- Real Estate-Related Debt
- Real Estate Securities (REITs, real estate operating companies)

*Will Combining Strategies
Impact Fundraising?*

Key Terms For RE Funds

	Closed-Ended	Open-Ended	Permanent Capital	JVs
Duration	Finite	Perpetual	Perpetual or long-dated	Finite or perpetual
Investment Period	3-5 years	None	Not typical	Not typical
Fundraising Period	12-18 months	Perpetual	Periodic	No
Fees	Management, acquisition, development fees, property management and lease override fees	Primarily management fees	Same as closed-ended	Same as closed-ended
Incentive Compensation	Distribution-based carried interest	NAV-based incentive allocation	<ul style="list-style-type: none"> • Distribution-based carried interest • Valuation-based incentive compensation • Carry crystallization 	<ul style="list-style-type: none"> • Distribution-based carried interest • Promote at stabilization • Carry crystallization
Investor Liquidity	None; secondary sales possible with manager approval	Yes, periodic subject to lock-ups and gates	Maybe (IPOs, secondary sales and sale rights)	None, subject to property sale rights

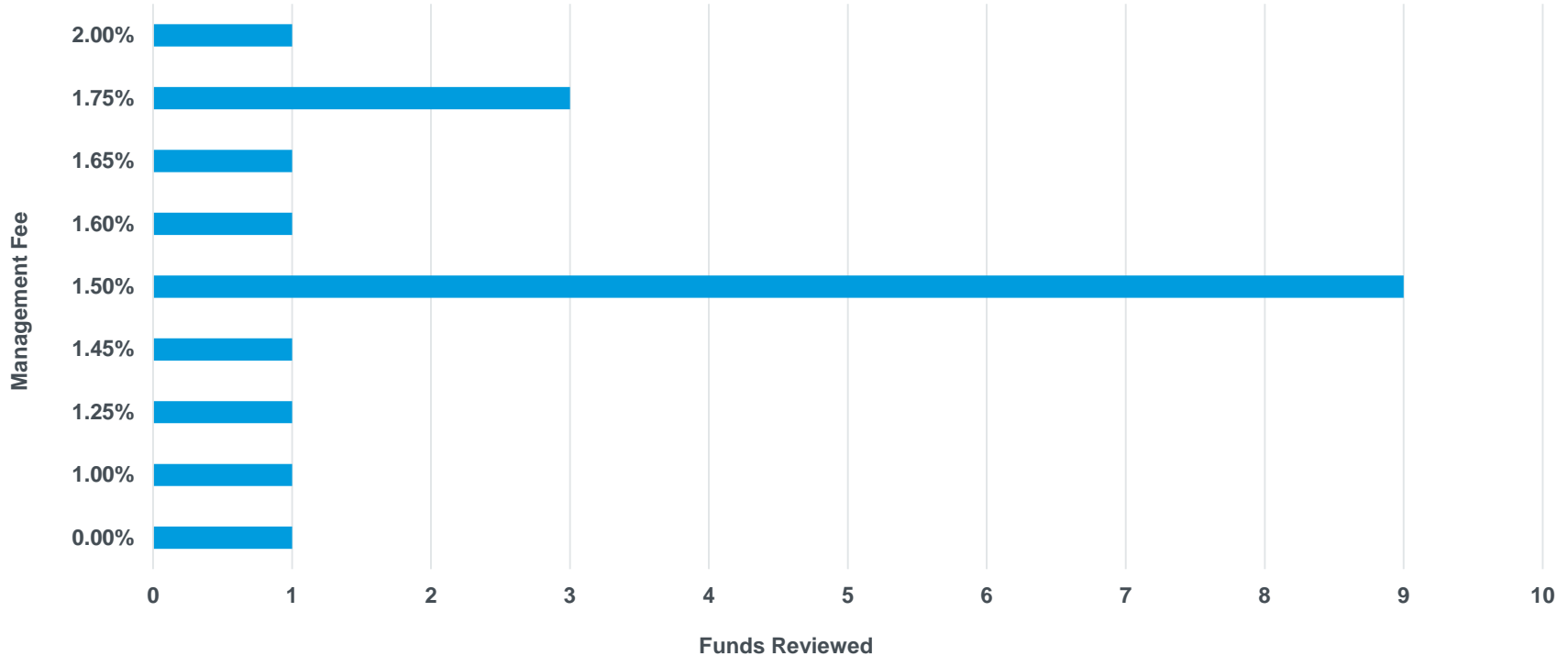
Fees & Promote are Key Differentiators

- Promote Structures Can Vary
 - Dual Waterfalls for Operating Income and Capital Event Proceeds
 - Earlier carry realization with greater clawback risk
 - “Super Carry”
 - Higher carry percentage for outsized MOICs and IRRs
 - Promote Crystallization
 - Convert promote into increased percentage of income and capital event proceeds
 - Promote Payable at Stabilization
 - Partial promote payments funded by investors

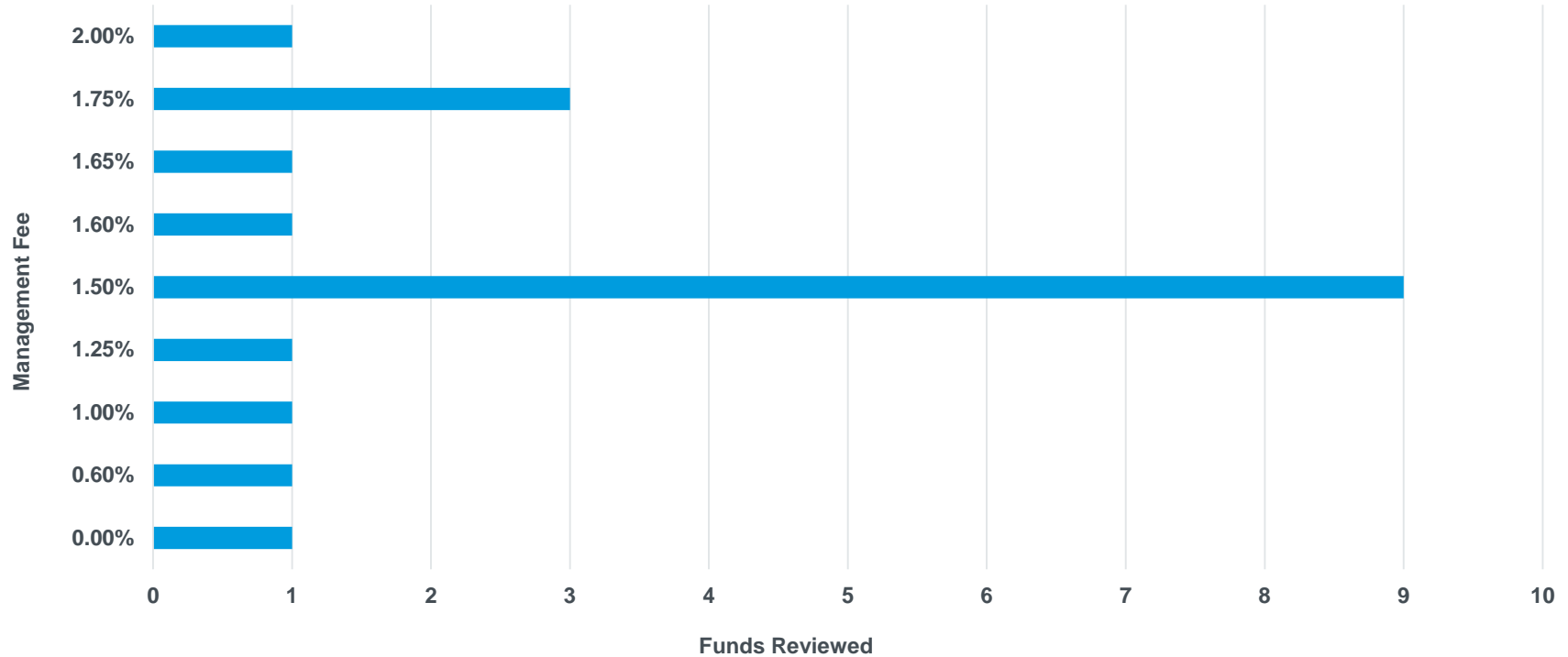
Fees & Promote are Key Differentiators

- RE Funds Can Be Fee Intensive
 - Management Fees
 - Typically, 1-1.75% (lower than typical private equity funds)
 - Property Management Fees
 - 2-4% of gross revenue
 - Acquisition/Disposition Fees
 - 1% but increasingly uncommon
 - Construction Management/Development Fees
 - 2-4% of hard/soft/budgeted costs
 - Lease Override Fees
 - ~1% of annual lease payments

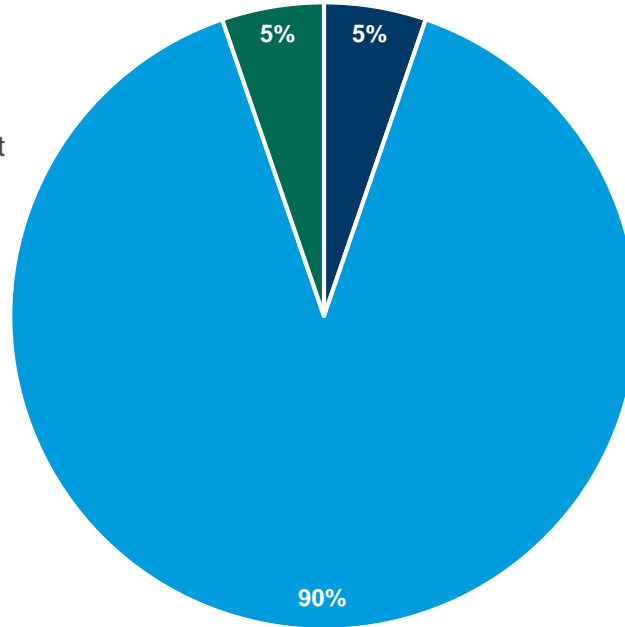
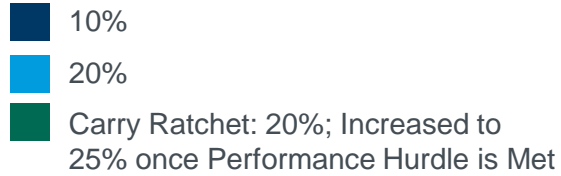
Management Fee During Investment Period



Management Fee Post Investment Period



Carried Interest



'33 Act Exemptions for RE Funds

- RE Funds typically rely on Regulation D or Regulation S.
 - Subject to certain exceptions, in a Reg D offering, all investors must be “accredited investors.”
 - In a Reg S offering, all investors must be non-US Persons.
 - Can utilize Reg D and Reg S within the same offering.
 - Form D and State Blue Sky Filings apply to Reg D offerings.

'40 Act Exemptions for RE Funds

Exemption	3(c)(1)	3(c)(7)	3(c)(5)
Limited to certain investor types?	No	<ul style="list-style-type: none"> • Qualified Purchasers • Knowledgeable Employees • Look-through rules apply 	No
Cap on # of investors?	<ul style="list-style-type: none"> • 100 "persons" • Look-through rules apply 	No	No
Limited to certain types of investments?	No	No	<ul style="list-style-type: none"> • Mortgages and Liens on RE • Interests in RE
Can be combined with other exemptions?	Yes with 3(c)(7) but only in parallel fund structures	Yes with 3(c)(1) but only in parallel fund structures	No

REITs

What is a REIT?

- A special entity to own and operate real estate and make and hold mortgages.
- A corporation, business trust or association combining the capital of many investors to own and, in most cases, operate a diversified pool of qualified income-producing real estate.
- REITs exist by virtue of the Internal Revenue Code and must comply with a number of requirements, the most fundamental of which are:
 - Distribute at least 90 percent of their taxable income to shareholders annually;
 - Derive most of their income from real estate held for the long term; and
 - Be widely held

What is a REIT?

- In exchange for satisfying these requirements, REITs (like mutual funds) are taxed typically only at the shareholder level.
 - Character of REIT's income (i.e., ordinary v. capital gain) passed through to shareholders.

Statutory Requirements

- Organizational
- Operational
- Distributions

Statutory Requirements

- Organizational
 - Can be formed as a type of domestic entity that can elect to be taxed as a corporation.
 - Elects to be taxed as a REIT.
 - Managed by directors or trustees (i.e., professionally managed).
 - Shares or certificates of beneficial interest must be transferable.
 - Diversity of ownership
 - Minimum of 100 shareholders
 - Cannot be “closely held” (50/50 test)

Statutory Requirements

- Organizational (Assets)
 - Asset Tests
 - 7 tests (75%, 25%, 20%, 25%, 10%, 10% and 5%)
 - Based on gross value of assets
 - Tested quarterly
 - At least 75% of gross assets must consist of real estate assets, cash/cash items and government securities.
 - “Real estate assets” means real property, interests in mortgages on real property and shares in other qualified REITs.
 - “Real property” means land and improvements to land.
 - “Improvements to land” means inherently permanent structures and their structural components.
 - Local law definitions do not control.

Statutory Requirements

- Operational (Income)
 - Income Tests
 - 2 tests (75% and 95%)
 - Based on gross income
 - Passive income (not active trade or business)
 - Tested annually.
 - At least 75% of gross income must consist of real estate related income (e.g., rent from real property, interest on mortgage loans, dividends received from other REITs, gain from the sale of real property and shares of other REITs).
 - At least 95% of gross income must consist of the same sources as the 75% test plus dividends, interest and gain from the sale of stock or securities.

Statutory Requirements

- Distributions
 - Annual Distribution Requirement
 - 90% of REIT taxable income
 - Excludes net capital gain
 - Computed before taking into account the REIT's deduction for dividends paid
 - Exceptions
 - Year-end dividends, subsequent year dividends, deficiency dividends, consent dividends
 - Preferential Dividends (only applies to private REITs)

Statutory Requirements

- Select Real Estate Issues for REITs
 - Rent cannot be based on net income or profit of tenant, but it can be based on gross receipts.
 - No more than 15% of rent can be attributable to personal property.
 - Lessor/REIT cannot provide more than a de minimis amount of “impermissible tenant services.”
 - Taxable REIT Subsidiaries (TRSs)
 - Used by hotel and healthcare REITs to generate rental income.
 - Arrangements between REITs and TRSs must be arms’ length.
 - Potential mortgage lending issues.
 - Prohibited transactions

Types of REITs

	Non-Listed REIT	Listed REIT	Private REIT
Public/Private?	Public	Public	Private
Target/Eligible Investors	Retail investors meeting state-mandated suitability requirements	Retail and institutional investors	Accredited Investors/Qualified Purchasers
Exempt from state blue sky?	No	Yes	Depends
Minimum Investment	\$2,500 (\$1,000,000 for no-load institutional class of shares)	None	\$1,000 per single preferred share
Current	Current Return	Total Return	Depends
Primary tax benefits	No corporate-level tax (stockholders taxed on distributions)	Same	Same, but can also: <ul style="list-style-type: none"> • Block UBTI for tax-exempt investors • Block ECI for foreign investors
Multiple common share classes?	Usually	No	No
Publish NAV?	Yes (FINRA rules require once a year, but most publish once a month)	No	No
Duration	May be limited life or perpetual	Perpetual	Perpetual

Types of REITs

	Non-Listed REIT	Listed REIT	Private REIT
Subject to on-going '34 Act reporting obligations?	Yes	Yes	No
Required to register under '40 Act?	Generally, no. There are exceptions.	No	No
Management	Externally managed	More likely to be internally managed than externally managed	Member managed
Management Compensation	<p>Asset management fees and expenses reimbursements</p> <p>Incentive compensation based on total return hurdle</p> <p>Promote: Subject to certain state restrictions</p>	<p>Executives (and other personnel) are employees of the REIT</p> <p>Executives get incentive compensation based on total return and other performance criteria</p> <p>If externally managed, same as non-listed REITs except not subject to NASAA restrictions</p>	None
Corporate Governance (i.e. director independence requirements)	State law; NASAA Guidelines	State law; Listing Rules	State law

Advisers Act Registration of Fund Managers

Are RE Fund Managers Required to Register with the SEC?

- SEC Staff has suggested RE Funds will be an area of focus
- Generally, “investment advisers” with over \$100M in regulatory assets under management (RAUM) are required to register with the SEC under the Investment Advisers Act of 1940 (Advisers Act) unless they can take advantage of an exemption
 - NY-based investment advisers can register if they have RAUM in excess of \$25M
- Advisers Act defines an “investment adviser” as any person who “for compensation, engages in the business of advising ***others...as to the value of securities or as to the advisability of investing in, purchasing, or selling securities***, or who, for compensation and as part of a regular business, ***issues or promulgates analyses or reports concerning securities.***”

Are RE Fund Managers Required to Register with the SEC? (cont'd)

- Advisers Act definition of “securities” does not include real estate but does include the following investment types (among others), which could be relevant to certain RE Funds:
 - Stocks
 - Notes
 - Participation in profit-sharing agreements
 - Investment Contracts
 - Fractional undivided interest in oil, gas or other mineral rights
- Form ADV lists real estate as “non-securities”

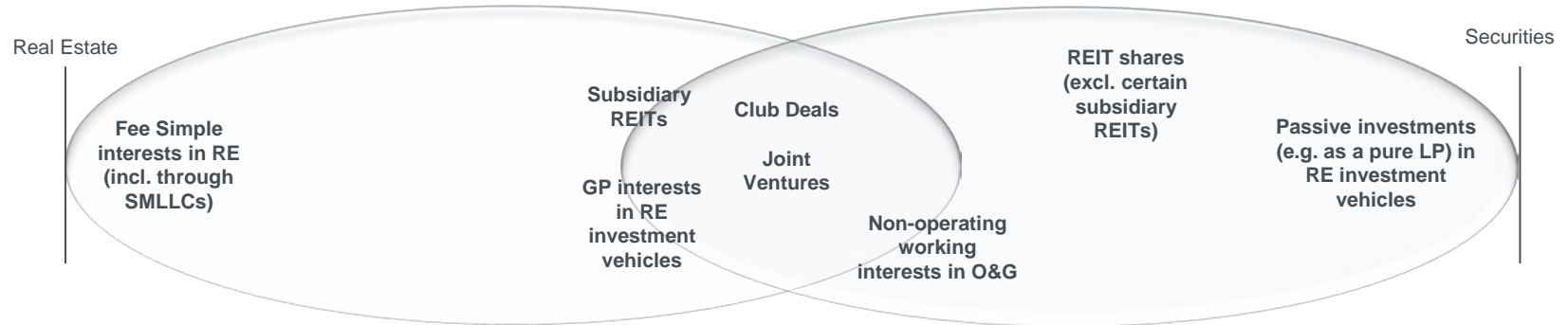
Does a RE Fund Hold Securities?

Howey Test: seminal U.S. Supreme Court case that sets out the general rule for determining whether an investment in real estate is an “investment contract” and, hence, a security. Under *Howey*, the following factors should be used to determine whether an investment in real estate is an investment contract:

- (1) *The investment of money*
- (2) *In a common enterprise*
- (3) *A reasonable expectation of profit from the efforts of others*

Does a RE Fund Hold Securities? (cont'd)

- Based on *Howey* and cases that followed, practitioners generally hold the view that real estate-related investments held by RE Funds fall along the following spectrum between true real estate and securities:



Does a RE Fund Hold Securities? (cont'd)

Whether a RE Fund manager is an investment adviser required to register with the SEC is a facts and circumstances analysis that turns, in large part, on whether an adviser's RE Funds invest in "securities." In addition to the *Howey* test, courts have looked at the following factors to determine whether RE investments are securities:

- Relative sophistication of parties to the investment transaction
- Participation in management by investors
- Scope of information available to investors
- Whether GP may be removed by investors without cause
- Whether the value of an investor's interest in the investment transaction is based on the value of the underlying real estate

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