

Practice Update

Investing Through a Private Real Estate Fund vs Individual Property Syndication

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Commercial real estate investing is an alluring and increasingly favorable method of wealth-building with a number of reasons that make it a smart investment: cash flow, tax write-offs, access to leverage, inflation hedge and exposure to an asset class historically resistant to the stock market. Individuals who want to passively invest in real estate private equity essentially have two choices: Build their own portfolio by investing in private individual property syndications or purchasing shares of multiple properties through private real estate funds.

This article intends to provide some insight into both investment vehicles and help investors find the sweet spot of risk/reward that they're comfortable with.

What is a real estate syndication?

A real estate syndication allows investors to pool their money with other investors in order to purchase property. One approach is to think of an individual property syndication as an individual share of stock and a real estate fund as a mutual fund. When you buy an individual stock, you have partial ownership of one company. When you invest in a mutual fund, you have partial ownership of

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multiple companies. Likewise, when an individual property is syndicated, all of the capital raised from the syndication goes to one specific property. When a fund syndicates, shares of investor money are spread over a number of properties. In both instances, the syndication process serves to make otherwise cost-prohibitive investments more accessible for the individual investor. This allows investors to participate in real estate investments on a much larger scale than they could on their own and provides a great option for individuals who want to access bigger and better investment opportunities.

How does a private individual property syndication work?

Private individual property syndications are typically structured as LLCs or LPs with a General Partner or Sponsor and non-managing members or Limited Partners (LPs). When an investor takes part in an individual syndication, the opportunity is straightforward: investment capital is committed to one asset class, one geographic location, one property manager, one investment strategy, one operator and one asset.

A sponsor, or syndicator, identifies an asset that meets their investment objectives. After submitting an offer and getting it accepted, the asset then enters a period where it is held in escrow. During this phase of escrow, the sponsor typically conducts due diligence, determines necessary financing and creates an investment package typically referred to as a Private Placement Memorandum (PPM) or Operating Agreement (OA). Amongst other things, the PPM or OA describes the investment offering and its terms, the risk associated with the investment and outlines how distributions and profits are paid (waterfall structure).

At this point, the sponsor determines the amount of equity needed and performs a capital raise, taking the offering to market and making it available to investors. When the capital is raised and financing

is put in place, the property is purchased. From this point, the sponsor serves as operator and manages the entire operation on behalf of the investors (this is not to say the sponsor physically manages the property, as this is often done by professional third-party property managers).

Pros of an Individual Property Syndication

- **Due Diligence** - The investor is able to identify a specific property, conduct due diligence on that property, evaluate the market where the property is located, access the rent roll, understand the expenses and analyze the pro-forma.
- **Limited Liability** - The advantage of protection from credit risk and liability beyond the asset.
- **Tax Efficiency** - Offers pass-through tax treatment, in particular, depreciation and interest expense.
- **Pooled Resources** - Provides access to larger investments and commercial properties with professional management.

Cons of an Individual Property Syndication

- **Lack of Liquidity** – Capital is locked in for whatever the term might be - in many individual commercial real estate syndications, an investor should plan for a 5-10 year time horizon.
- **Lack of Diversification** - Your investment is committed to one asset.

What is a private real estate fund?

In its simplest form, a private real estate private equity fund is a partnership established to raise equity for ongoing real estate investments. A general partner (GP), or Sponsor, creates the fund. The sponsor then raises equity through investors, known as limited partners (LPs), who invest their capital in the partnership. That capital, along with money borrowed from banks and other lenders, will be

invested in real estate assets or acquisition opportunities.

Most real estate funds adhere to a blind or semi-blind structure, meaning only one or some of the assets have been identified at the time you invest. Here, an investor commits capital to a fund manager, who then makes several smaller commitments to real estate investments, which local operating partners manage. The syndication process of a fund is similar to that of an individual property, the difference being the investor capital raised through syndication is pooled together to purchase multiple properties, giving the investor diversification over a larger pool of assets.

How does a real estate fund work?

Private real estate funds are run by experienced managers who create the investment strategy, guide the use of investor capital and handle all aspects of the fund's performance. By investing in a real estate fund, investors are capable of diversifying their real estate holdings between different markets and property classes.

Pros of a Real Estate Fund:

- **Diversification** - Risk is spread around as investors own shares of multiple assets, and the risk/return that comes with them.

Example: The investment opportunity includes several pieces of property, spread across several asset classes, located in several geographic locations.

- **Liquidity** - The extent of liquidity funds offer can vary, but normally investors have greater access to their capital.
- **Tax Efficiency** - Investors can take advantage of pass-through tax treatment, in particular, depreciation and interest expense.

- **Limited Liability** - Offers pass-through tax treatment, in particular, depreciation and interest expense.
- **Pooled Resources** - Access to *multiple* large investments and commercial properties with professional management

Cons of a Real Estate Fund:

- **Manager Risk** - Investor uncertainty is no longer relegated solely to the asset itself, but also the fund manager and their investment template - there will always be some level of variance amongst fund managers.
- **Lack of Control** - Sponsors decide when to refinance, sell, withhold distributions, etc.

Choosing the Right Option For You

Whether investing in an individual property syndication or a real estate fund, some constants remain the same. The trust and integrity of the sponsor or fund manager is of critical importance. It is also necessary to make sure their track record, strategy, assumptions and underwriting is aligned with the investor's risk tolerance and goals.

Through the syndication process, typical investors have the opportunity to invest in properties they otherwise would not be able to. In addition to the sizeable return potential, both investment models offer investors an additional layer of protection between the asset and themselves, the ability to leverage the expertise of a professional, the advantageous tax treatment that comes from direct real estate co-investment, and access to an asset class that lacks correlation to the public markets.

Ultimately, there is no one-size-fits-all strategy, the right solution is based on the individual and may include a combination of both real estate investment methods. We suggest that investors concentrate on

their investment objectives when deciding how best to gain their desired real estate exposure.

Written in partnership with Brian Adams at Excelsior Capital.

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