



# nerej

## **TIC sponsors have diversified their investments mostly to include real estate investment funds**

September 25, 2008 - Front Section

Many TIC sponsors have diversified their business into investment vehicles other than tenant-in-common structures. Often, these new business models include multi-member real estate investment funds. These private funds allow sponsors to take advantage of investment opportunities that may not fit the narrow requirements of a TIC offering but, nevertheless, offer attractive potential returns. These funds go by various names - opportunity funds, value-added funds, stabilized funds, mezzanine funds, note offerings and other flavors of funds. This article will discuss the characteristics of each of these types of funds as well as some important differences.

### Opportunity Funds

Opportunity funds (also known as value-added or vulture funds) typically invest in multiple, income-producing properties. Traditionally, these funds purchase non-stabilized properties and utilize capital expenditures or better property management to return the properties to stabilization and sell at a profit. More recently, opportunity funds are targeting distressed owners who need to unload properties quickly. Other recent strategies include buying commercial mortgage debt at a discount from investment banks and other lenders; purchasing commercial properties from owners who cannot refinance their property due to changes in lending standards; and purchasing residential properties at steep discounts. Because these funds are perceived to have more risk than funds investing in stabilized properties, opportunity funds typically offer investors a preferred return of between 10 - 12%. After the preferred return is paid and the investors receive a return of their capital, the remaining proceeds are split, with the sponsor often receiving 20% and the investors receiving the remaining 80%. Some sponsors utilize a tiered structure where the sponsor's carried interest increases as the investors' return increases. In some cases, a sponsor's share of income can reach 50% in a tiered structure. In addition to sharing income, sponsors often receive a 1 - 2% annual management fee for managing the fund. Other fees can include acquisition fees, leasing fees, refinancing fees and disposition fees. Typically, opportunity funds are "blind pool" funds in which no particular investment is identified in the offering documents. Instead, management is given broad authority to invest in properties that meet certain criteria.

### Note Offerings

Note offerings differ from other real estate funds in that the investors are typically purchasing an interest in a promissory note instead of an equity interest in an entity. The interest rate payable on the underlying notes in a notes offering typically ranges from 8 - 14%. In some circumstances the notes are structured to provide additional interest payments upon the successful sale of a property. Often, the sponsor entity or a principal of the sponsor entity will guaranty the notes. Alternatively, some notes are secured by an indirect interest in real estate acquired by a sponsor. Many note programs are utilized by the sponsor to provide capital for purchase deposits, due diligence costs,

lender fees, other pre-closing expenses and the initial equity required to close the purchase of a property that will be syndicated.

#### Mezzanine Funds

Due to current problems in the credit markets, real estate investors are finding it nearly impossible to obtain high loan to value, non-recourse acquisition or refinancing debt for commercial real estate. Accordingly, sponsors of real estate investment programs often need equity or debt financing on top of the amount provided by the first lienholder. Mezzanine funds, which act as a private equity lender, are one source for this financing. Mezzanine funds typically offer investors a preferred return of between 8 - 12%. Similar to opportunity funds, the investors and the sponsor split any income in excess of the preferred return, with the split commonly set at 80% to the investors and 20% to the sponsor. Some sponsors utilize a tiered structure where the sponsor's carried interest increases as the investors' return increases. Mezzanine fund sponsors also typically receive fees similar to the fees paid in an opportunity fund.

#### Stabilized Funds

Sponsors with expertise in a certain property type often establish a fund which will limit its investments to that property type (such as medical office or industrial). Although the target properties are often stabilized, such properties may not be suitable TIC investments due to factors such as size and the need to assume financing. Because these funds are perceived to be less risky than opportunity funds, stabilized funds typically offer investors lower preferred returns between 7 - 9%. As with opportunity funds, the sponsor often receives 20% of the remaining income, with the investors receiving 80%. Sponsors also receive fees similar to the fees paid in an opportunity fund. Although the sponsor may identify some of the potential properties upfront, stabilized funds are typically "blind pool" funds where no particular investment is identified in the offering documents.

Wythe Michael is a shareholder of Hirschler Fleischer, Richmond, Vir.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540