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## Structuring transactions in this economy: raising private equity

The United States and global financial markets have suffered unprecedented upheaval, including the implosion of storied global investment banks, the expenditure of hundreds of billions in federal government bailouts, a seemingly unending succession of bank failures and a mass exodus of capital providers from the traditional credit, capital and stock markets. This extended upheaval in the credit and capital markets has resulted in a general undersupply of capital across the United States that, in turn, has resulted in a fertile field of investment opportunities for investors seeking to purchase and develop real estate. However, with credit availability virtually nonexistent and asset valuation seemingly based more on guesswork than facts, a weary investor class seeks a return to fundamental deal analysis and structuring over novel and short-term financial investments. It is becoming apparent that the transactions that will successfully compete for the equity capital that now sits cautiously on the sidelines must exhibit a return to the fundamental principles of sourcing, underwriting, structuring and execution.

In this environment of financial scarcity, many developers, financiers and entrepreneurs continue unabashed to seek sources of capital for a variety of real estate transactions and development projects. In the absence of a strong credit market, a common source of capital has been raising private equity investments through a private real estate fund. A fund is an entity organized to invest equity funds raised from multiple investors in a target category of investments. This article discusses the basic economics and considerations concerning capital raising, deployment and disbursement of a fund.

In connection with the solicitation of the offering, investors are typically provided a private placement memorandum, which details the opportunities, risks, parameters and economics of the fund. While there



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is room to market the opportunity and the strength and experience of the issuer's management team, the private placement memorandum is the first line of defense against investment underperformance or failure.

Accordingly, the private placement memorandum should fairly and completely detail all of the risks inherent with the investment and should not be used solely, or even primarily, as a marketing tool.

The private placement memorandum (together with the governing document of the fund) should specifically detail the scope and limitations of the investments of the fund. The scope and limitations should be broad enough to permit the issuer to source a sufficient number of quality transactions for the fund, but narrow enough that the business model will be clear to potential investors. For example, scope limitations might include: commercial or residential real estate; acquisition of distressed or performing assets; construction of new assets or rehabilitation of existing assets; and/or development of new projects such as renewable energy generation. Other scope and limitations might include the geographic location of target assets and whether an advisory board must be consulted prior to making investments. It is also important to establish the duration of the fund so that it is clear to investors how long their cash investment can be held.

Given the course of events in the U.S. economy over the past two years, it has become increasingly important that the private placement memorandum detail with specificity the type and amount of leverage, if any, that can be used in the under-



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lying investments. For example, in lieu of seeking scarce traditional bank financing, the fund may seek to obtain more-accessible financing insured through the U.S. Department of Housing and Urban Development,

which, in many cases, limits project leverage. If all or a portion of the target projects qualify in both scope and location, the fund might also seek supplemental financing through low-income housing tax credits, new markets tax credits or renewable energy tax credits. Detailed disclosure in the private placement memorandum of the application of leverage in the fund's investments serves to provide good disclosure and to market the fundamental economics of the target leveraged structure.

The private placement memorandum also should detail the economics of the investment in the fund, including the compensation of the fund sponsor, timing of capital investments and distributions of capital and profits. Typically, at the infancy of the fund, the fund sponsor seeks "capital commitments," which are firm commitments from investors to invest a set amount of capital only when actual investments have been identified. Once an actual investment has been identified, the fund would issue a "capital call" to the committed investors and each committed investor would be contractually required to deliver the applicable portion of the total capital specified within a prescribed amount of time. The failure of an investor to deliver its portion of the capital call would be a default under the governing document of the fund, subjecting the investor to specified remedies of

the fund, which can include loss of the entire investment or forced sale, plus other actions available under law. While the capital commitment structure does not provide the fund with immediate cash, there is a benefit to the fund because the investors' preferred return on the capital commitments does not start to accrue until the fund is ready to deploy the capital and the investors, in fact, contribute capital to the fund. In short, the capital commitment structure creates efficiencies in the cost of capital for the fund sponsor.

Once the fund begins to generate revenue, distributions typically are made to investors and the fund sponsor through a "waterfall" structure. In the waterfall, investors typically receive a first priority distribution based upon their capital contributions, commonly referred to as a "preference" (e.g., a return of, and on, their capital contributions at an agreed upon per annum rate). After the preference is distributed, capital contributions are returned to the investors and then profits are distributed to the investors and fund sponsor. The fund sponsor's percentage of the profits, referred to as its "carried interest," is the fund sponsor's return for services provided to the fund.

This article details just a few points for a fund sponsor to consider when structuring a fund to raise equity for general growth or with respect to particular projects. There are many variations on the foregoing and additional structural implications that should be taken into consideration with appropriate advisers when structuring and raising capital for your particular fund. Importantly, the solicitation of equity funds implicates federal and state securities laws. Accordingly, it is important to work out these structuring details as early as possible and certainly before soliciting investors or drafting the offering documents for the fund.▲