REGULATORY UPDATE

Retail Real Estate Vehicles: Recent Developments

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Real estate private equity sponsors and investment managers increasingly are focused on strategies to raise capital from retail investors, and a number of innovative products have been launched to capitalize on this growing market opportunity. This article provides an overview of retail real estate vehicles (including differences between the current product vintage and certain products), key considerations for sponsors to consider when launching these products, and structuring approaches relative to a sponsor's existing institutional products.

High Demand for Retail Products

Alternative retail products represent an opportunity that is estimated in the tens of trillions of dollars and is still largely untapped. Alternative investment fundraising totaled $73.1 billion in 2023, up 252% from $29.0 billion in 2019.[1] However, high-net-worth investors (> $1 million net worth) globally represented $83 trillion as of the end of 2022,[2] and mass affluent investors (< $1 million net worth) are expected to account for more than $47 trillion by 2025.[3] Thus, real estate private equity sponsors and investment managers that are able to offer attractive investment products have the potential to raise significant amounts of capital from retail investors.

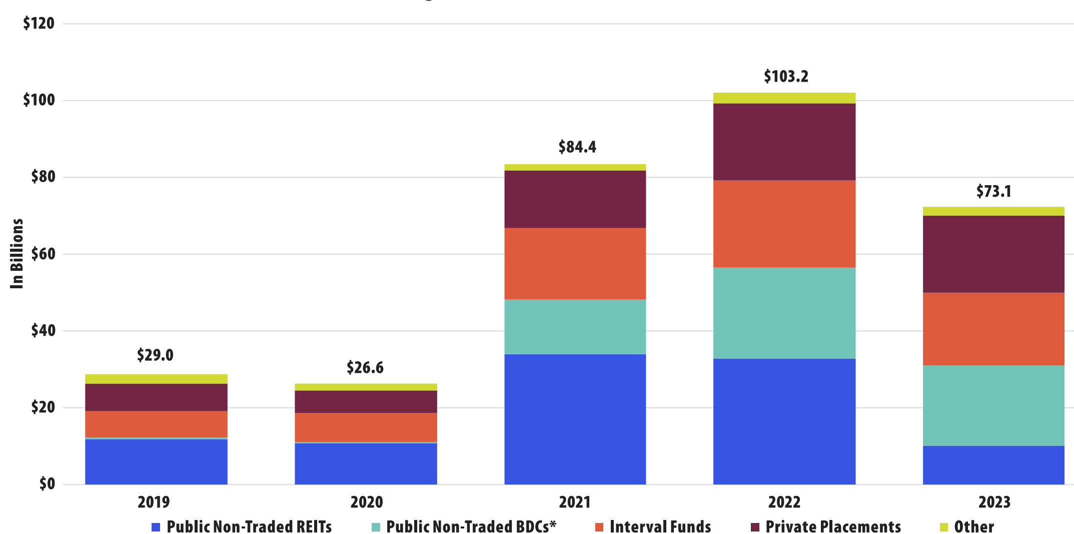
Exhibit 1 shows non-traded alternative investment fundraising trends from 2019–2023.

Overview of Retail Real Estate Vehicles

Real estate assets lend themselves to permanent capital structures via retail vehicles that generally can elect REIT status. REITs are subject to an extensive tax regulatory regime that requires them to distribute at

1. Robert A. Stanger & Co.
2. Capgemini Research Institute.
3. Global Data Wealth Markets Analytics.

Exhibit 1: Alternative Investment Fundraising



Source: Robert A. Stanger & Co., Inc.
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least 90% of their income annually. REITs may, and most do, distribute at least 100% of their income annually. The distribution requirement imposed by the tax regime increases the attractiveness of REIT vehicles to retail investors by providing a predictable yield and the potential for appreciation.

Three primary types of unlisted, continuously offered REITs are generally marketed to retail investors:

- **Public 1940 Act REIT:** This REIT elects to be registered as an investment company under the 1940 Act. It can be structured as an interval fund or a tender offer fund, offering periodic liquidity to investors, and registers its shares under the 1933 Act to facilitate a public offering. These REITs generally are not subject to any investor eligibility standards.
- **Public Non-Traded REIT:** This REIT is structured to avoid 1940 Act registration but also offers periodic liquidity to investors and generally registers its shares under the 1933 Act to facilitate a public offering. Unlike a 1940 Act REIT, however, it must register its public offering in various states and comply with state blue sky securities laws, including investor suitability standards and concentration limits.
- **Private Placement REIT:** This REIT operates under registration and offering exemptions under the 1940 and 1933 Acts. As a result, unlike a public non-traded REIT, the private offering is not subject to SEC registration (unless the REIT has more than 2,000 investors) and is not subject to blue sky state review. However, an increasing number of privately placed REITs are voluntarily electing public company status and are subject to reporting under the 1934 Act similar to a public non-traded REIT. This vehicle also may offer periodic liquidity to investors and will impose an "accredited investor" standard.

A few key features of retail real estate vehicles are as follows:

Retail Is Sold, Not Bought

Successfully distributing a product via retail channels is a very different enterprise than an institutional fundraise. The distribution process for retail is more reliant on third-party channels, including wirehouses, independent broker-dealers (IBDs), and registered investment advisor (RIA) platforms. Products must be structured in ways that are attractive to these distribution partners—i.e., economic incentives to support distribution and servicing, such as appropriate sales loads and distribution/servicing fees. Internal marketing support and partnering with a distributor are critical because a sponsor's institutional reputation alone will not ensure success in the retail market.

In most cases, retail vehicles are marketed and sold through a dealer manager. The dealer manager will enter into agreements with wirehouses, IBDs, RIAs, and other distribution partners to promote the offering. The dealer manager can be a third party or, if the sponsor has its own affiliated broker-dealer, the affiliated broker-dealer can serve as the dealer manager. Sponsors need to ensure their distribution partners are appropriately licensed with the Financial Industry Regulatory Authority (FINRA); licensing requirements will vary depending on the nature of the offering and the compensation being paid and received.

Share Classes

Retail REITs often have multiple share classes that pay varying upfront sales loads or placement fees, distribution and/or servicing fees, and for the non-1940 Act REITs, advisory fees, depending on the distribution channel through which an investor comes in. In particular, certain products may offer an institutional share class with discounted advisory fees for larger investors, or in order to incentivize early investors and help grow the vehicle more quickly, some non-1940 Act REITs offer one or more "founders" share classes with lower advisory fees or temporary fee waivers for investors who invest during the escrow period or initial fundraising stage. These variable advisory fee arrangements are not permitted for 1940 Act REITs or certain private placement REITs that are subject to the "preferential dividend" rules under the US tax code.

Liquidity Programs

Retail products typically accept new subscriptions and provide net asset value (NAV) updates on a daily, monthly, or quarterly basis. Retail REITs in the current vintage tend to be perpetual-term vehicles compared with older-vintage public non-traded REITs, which were finite-life products that sought an exit liquidity event after a five- to seven-year investment period by listing their shares

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on a stock exchange or through an M&A transaction or wind-down. Instead of that type of exit event, retail REITs today typically provide periodic liquidity to their investors, beginning shortly after breaking escrow and commencing operations. For instance, most public non-traded REITs offer a share repurchase program that provides for monthly or quarterly liquidity at then-current NAV per share, often capped at 2% of NAV monthly and 5% of NAV quarterly. For private placement REITs, redemption programs are more varied and in some cases nonexistent, but a number of recent products offer a share repurchase program similar to public non-traded REITs. For 1940 Act REITs, tender offer funds typically have discretionary redemption programs (e.g., 5% of NAV quarterly), and interval funds have mandatory redemption programs and generally must effect repurchases on a fixed periodic basis for 5% to 25%. Except for interval funds, sponsors of retail REITs have the right to limit or suspend a share repurchase program in any month or quarter, although such an action likely would have a very negative impact on existing investor sentiment and hamper future distribution efforts. Some additional key differences between the three types of retail real estate vehicles are set forth in "Key Differences Between Retail Real Estate Vehicles."

Key Considerations for Sponsors

Seed Portfolio and Formation

A threshold question is whether the retail vehicle will be a "blind pool," with a defined investment strategy but no pre-identified assets, or if the vehicle will be launched with an identified seed portfolio. If there is a seed portfolio, it can be structured in a number of ways. If the sponsor has an existing institutional fund with a similar investment strategy, the retail REIT could coinvest alongside the existing fund. The sponsor could also purchase assets and "warehouse" them until the retail REIT raises sufficient proceeds. Real estate provides for easy "mixing and matching" among assets, allowing a sponsor to combine assets from multiple portfolios or funds, including via a "roll-up" transaction.

Sponsors should consider any consents required from limited partner advisory committees, limited partners, or other third parties (e.g., joint venture partners, lenders, ground lessors). Advanced consideration should also be given to any financial statements or accounting requirements (e.g., pro forma or historical financial statements), which may require significant lead time, particularly if the retail REIT will be a public SEC reporting company. Sellers may also want tax protection to preserve tax benefits if they are contributing assets via an UPREIT transaction (described later). In addition, 1940 Act REITs will need to focus on structuring these types of seeding transactions to comply with statutory restrictions on transactions with affiliated persons.

Anchor Investors

In a competitive fundraising market, identifying one or more larger anchor investors for the retail REIT could facilitate the marketing process by providing an early infusion of capital and having a respected institutional investor "validate" the investment strategy and sponsor's management team. As noted above, depending on the nature of the vehicle, the sponsor will often give anchor investors preferential economic terms, such as fee discounts or waivers, and possibly management fee revenue sharing.

Valuation and Conflict Considerations

Valuation and conflict issues are also important to consider early in the process. Related party transactions and other conflict scenarios that could potentially impact valuations or fairness should be properly disclosed and mitigated, and appropriate policies should be established. Related party transactions will often require approval of the REIT's independent directors, and in some cases, the sponsor may obtain an independent third-party valuation opinion. Allocation policies and coinvestment policies should clearly disclose how the sponsor intends to allocate investment opportunities across multiple sponsor-advised products or determine appropriate coinvestment opportunities for the sponsor's products with overlapping mandates. Further, investors and distribution partners are increasingly focused on retail REITs' valuation guidelines and NAV calculation procedures, including the role of independent valuation advisors in calculating or reviewing NAV and asset-level valuations, and the sponsor's use of independent

appraisals to value assets on a periodic basis. For 1940 Act REITs, sponsors need to consider both of these issues with the additional statutory lens applicable to registered investment companies, including compliance with Rule 2a-5 with respect to fair valuation of the REIT's non-market-priced portfolio, and whether the sponsor needs to seek exemptive relief from the SEC to permit the 1940 Act REIT to invest in negotiated transactions alongside other sponsor-managed funds and proprietary accounts.

Structuring Approaches

REITs provide for flexible structuring and often use an umbrella partnership, or UPREIT, structure. In an UPREIT structure, the REIT serves as general partner of a limited partnership (an operating partnership, or OP) and generally owns a substantial majority of the interests in the OP (called OP units). The OP in turn holds substantially all the REIT's assets and conducts substantially all its business. OP units are designed to be economically equivalent to REIT shares and receive the same distributions per unit as a share of the REIT. OP units may be redeemed, at the option of the holder, for cash (or, in the REIT's discretion, REIT shares) on a one-for-one basis.

Although retail investors receive REIT shares in the offering (not OP units), using an UPREIT structure has a number of benefits. First, it allows for future tax-deferred property contributions to the OP by third-party sellers in exchange for OP units. Second, it facilitates issuances of incentive compensation or performance fees to the REIT's manager and employees. Third, it may facilitate the initial roll-up structuring if bringing in seed investors or an existing seed portfolio. Finally, certain high-net-worth individual investors, particularly those that already own other real estate investments, may prefer to contribute cash to the OP

Key Differences Between Retail Real Estate Vehicles

	Public 1940 Act REIT	Public Non-Traded REIT	Private Placement REIT
Target Investors	Retail investors without restriction “Qualified clients” if charging a performance fee on capital gains	Retail investors, subject to state-mandated suitability requirements and concentration limits	“Accredited investors” only
Regulatory Restrictions	Investment Company Act	Blue sky registration North American Securities Administrators Association (NASAA) REIT Guidelines	Private placement—must avoid “general solicitation” when communicating with investors, unless sold via Rule 506(c)
Advisory Fee Structure	All share classes must pay the same fee. SEC exemptive relief is required to pay advisor in shares or to offer multiple share classes.	Fees can vary by share class.	All share classes generally must pay same fee if REIT remains private. Fees can vary by share class if REIT commences public company reporting (required at 2,000 investors or earlier upon election).
Leverage	Debt is limited to 33.3% of total assets (less liabilities and indebtedness not represented by 1940 Act leverage). Nonrecourse property or JV-level debt is not subject to 1940 Act leverage limits if not consolidated for accounting purposes.	Per NASAA’s REIT Guidelines, debt is generally limited to 300% of net assets (unless approved by the independent directors). This approximates borrowing 75% of the cost of an investment.	No statutory or regulatory limit
Periodic Reporting	Semiannual and annual reports furnished to investors and filed with the SEC Quarterly disclosure of portfolio holdings filed with the SEC Monthly portfolio holdings furnished confidentially to the SEC	Public company reporting (10-K, 10-Q, 8-K, etc.) under 1934 Act	No ongoing reporting unless the REIT has more than 2,000 shareholders or elects public company status (and then public company reporting under 1934 Act) Public reporting also triggered if the private placement converts to a public offering
Time to Market	4–6 months (SEC registration)	9–12 months (SEC and state blue sky registration)	3–6 months (private, no registration)

rather than the REIT to advance certain individual tax and estate planning objectives.

Conclusion

A number of sponsors have found that, when properly structured, marketed, and incentivized, retail products can complement institutional fundraising in several ways. For example, in terms of client and asset diversification, retail products can provide access to a new investor base and the opportunity to launch strategies and pursue asset classes that may not be a focal point for institutional investors. These permanent capital vehicles can also serve as a dependable, longer-term source of assets under management and can help “fill the gap” between institutional fundraises because retail funds can be continuously offered with unlimited terms. ■

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