Ten things you **need to know** before you invest in a real estate fund.

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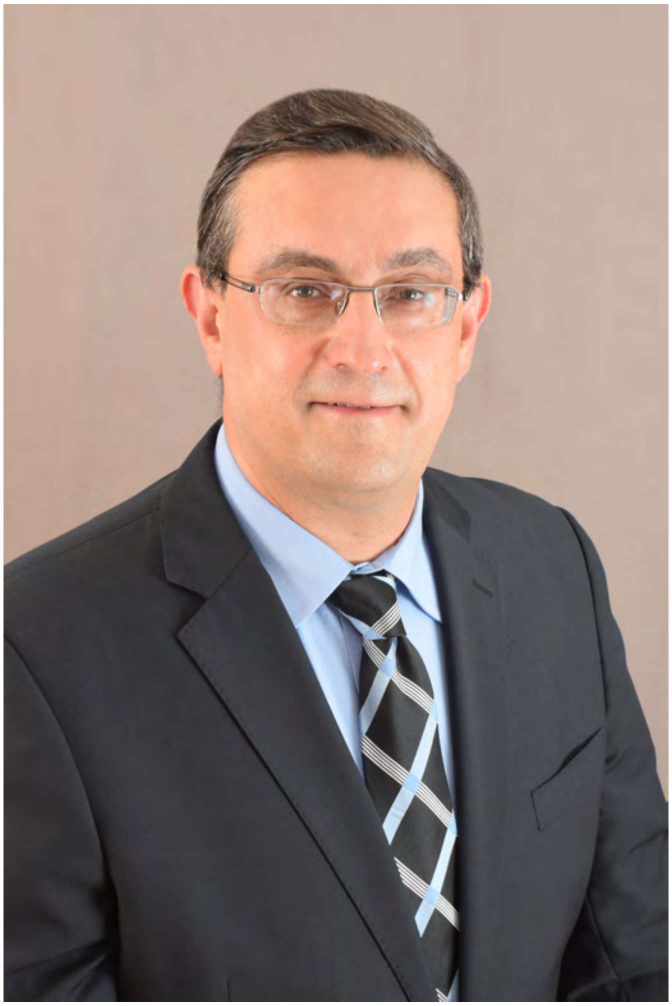

ABOUT THE AUTHOR

MIKE ZLOTNIK

Mike Zlotnik has been a debt and equity investor in real estate for since 2000.

He started his career and had spent nearly 15 years in the information technology field managing Risk, Business Intelligence and Quality of complex systems, software and processes.

While building a successful career in IT, Mike's passion has always been real estate investing because of its outcome predictability and well understood risks. In 2009, Mike joined Tempo Funding, LLC (Mortgage Pool Fund) as a managing partner, and Vice President of funding operations.

Starting from January 2014, Mike has assumed the responsibility of a CEO and has since founded TF Management Group, LLC, launching 4 new real estate investment funds, TF Investment Fund II LLC (Income Fund), Tempo Opportunity Fund LLC (Growth & Income Fund), Tempo Growth Fund LLC (Growth Fund) and Tempo Income Fund LLC (Income Fund).

Mike holds a Bachelor's degree in Mathematics from Binghamton University. Mike is a member of multiple real estate and investor mastermind groups such as Collective Genius, Freedom Founders, Venture Alliance, CA Investors (Private).

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Looking for Growth? Or Income?

TOF

TEMPO
OPPORTUNITY FUND LLC

- 1/3 GROWTH & 2/3 INCOME
- Open-ended (ever-green)
- Target ROI = 10-13%
- IRA Friendly
- Diversified portfolio of value-add and cash-flowing projects

TGF II

TEMPO
GROWTH FUND II LLC

- GROWTH FOCUSED
- Closed-ended
- Target ROI = 12-20%
- Tax efficient
- 5-7 years term
- IRA Friendly

TIF

TEMPO
INCOME FUND LLC

- INCOME FOCUSED
- Open-ended (ever-green)
- 7% cumulative preferred return
- 2-year lock-in period
- Target ROI:
  - 8-12 % Class A-C
  - 12-15% Class D1-D4 (Discount Lots)
- IRA Friendly
- Diversified portfolio of cash-flowing projects

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1. Is it safe?

Safety is relative. Some funds have a history of double-digit returns, but one day they crash and burn; while some other funds show poor initial performance, but come out great at the exit point.

Like with many things, the lesson is, "Don't judge the book by its cover." If any fund manager tells you their fund has "guaranteed safe" returns, run away. Fast. Not only can't a fund manager guarantee a return, the manager is breaking the law by doing so. Call Bernie Madoff if you want a "guaranteed safe investment."

Instead, the safety of your investment correlates directly with the process in which the fund manager secures the assets in which the fund invests. There are four primary factors:

1. Investment strategy
2. Diversification
3. Deal underwriting criteria
4. Downside protection

1. INVESTMENT STRATEGY

Some strategies are more risk averse than others, and, as a result, the return on the more risk-averse investments might not be as high as the return on more risky strategies.

Examples of investment strategies include funding borrowers with hard-money or bridge loans, leveraged and unleveraged commercial property, residential flippers and more.

Market cycles also help determine which investment strategy is the best. Look for funds with investment strategies that make sense reflecting on the current economy and the condition of that investment strategy within the market cycle.

For instance, COVID-19 has created a number of opportunities for strong

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growth investing repositioning certain commercial real estate asset classes such as hospitality and retail.

Redevelopment of hotels to multifamily housing and conversion of retail to self-storage are a few examples of this strategy.

2. DIVERSIFICATION

Funds that diversify their real estate holdings among multiple dimensions such as asset class (residential/multifamily/self-storage/office/industrial/retail), geography, and sponsors or borrowers are less likely to be subject to the risks of funds that put all their eggs in the proverbial basket.

3. DEAL UNDERWRITING CRITERIA

Strong due diligence on the project sponsor, the subject property and the answer to a question as simple as "How will this project do under the stressed conditions?" are really the backbone of a prudent underwriting process.

4. DOWNSIDE PROTECTION

How will the investment fare if things go wrong? What protects the principal of the investment?

Understanding and enhancing "safety" mechanisms is what creates downside protection. For example, investing in a note secured by the 1st lien mortgage at low LTV ("loan to value") ratio usually has downside protection.

On the fund level, it is a combination of many investments that fit this philosophy that makes the fund relatively well positioned with downside protection.

✅ ***Takeaway:*** *No fund or fund manager can ever guarantee the safety of an investment. Your research can go a long way to ensure that the necessary criteria listed above is being followed.*

2. What is the expected return?

Like safety, returns are never “guaranteed.” Returns are projections or targets, based on the specific fund’s strategy, asset allocation model, risk management, and other factors.

Fund managers usually set a “target return” based on their mathematical projections. Prudent managers set expectations conservatively based on the “Risk Adjusted Return,” and work hard to outperform the projections. However, there are clever and unscrupulous people out there who promise high returns to attract investors without the “risk adjusted” underwriting in mind.

They use the most optimistic and aggressive assumptions to come up with the highest possible theoretical returns to attract investors.

The lower the risk usually means the lower the projected payout; the higher the risk means the payout is usually greater. Finding the right balance between safety, risk, and payout is a hallmark of the best fund managers.

It is of paramount importance to focus on the “Risk Adjusted Return” instead of the top line target return.

One important comment about the Preferred Return (“Pref”): Pref is not guaranteed. Pref is simply a mechanism that gives investors seniority in the distributions before performance fees or performance split kicks in. If the investment works well, then full Pref gets paid, and the performance split kicks in. On the other hand, if the investment underperforms, then even the Pref might be underpaid.

✅ *Takeaway: Look for a fund that strikes the right balance between your risk tolerance and your desire for high returns. Many fund managers offer multiple funds from which you can find the one that meets your risk/reward criteria.*

3. How am I paid?

There are two main ways funds pay investors:

1. Distribute operating income on a periodic basis (e.g. quarterly), aka cash-flow
2. Distribute capital gains and return capital upon sale or refinance of assets Income focused funds usually deliver most of their return in the form of current income distributions.

Growth & Income funds typically have some current distributions and some appreciation ("unrealized gains") or future distributions upon sale or refinance of growth investments.

Growth Funds normally have minimal initial distributions as most of their projects need to undergo "value-add" work, and get sold or refinanced upon which they have large distributions of capital gains and/or return of capital. Fund Total Return = Income return + Growth return.

Some funds have very steady return streams, and some funds have "clumpy" returns. Most of the growth projects deliver these "clumpy" returns once the value-add strategy is fully executed and refi and/or sale event takes place.

If you are looking to invest into an Income fund, history of distributions is helpful to predict future distributions, but market conditions may have an impact, e.g. "Yield Compression" environment may lower income in the future vs. the past.

If you are looking to invest into a Growth fund, history of distributions have little impact on the total return because most of the income comes on the back-end at the sale of asset(s). It is much more valuable to look at each asset of the Growth Fund, cost basis, value-add strategy, and the likely future value of these investments and project capital gains.

If you are considering a Growth and Income Fund, then you look at what portion of the fund investments are long-term value-add projects vs. current income generating deals.

✅ *Takeaway : Investing for Growth strategy usually sacrifices current income to receive a greater return upon the sale of the investments. Investing for Income typically is more of a "steady-eddie" strategy and historic returns may help predict future performance. Your investment capital objectives should match the fund strategy in order to be a good match.*

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4. What are my tax consequences?

Real Estate is the most tax-advantaged asset class. Some of the major benefits are:

- Depreciation
- Amortization
- Appreciation
- Cashflow

Different investments generate different type of income:

- Passive income (Collected Rents minus operating expenses, minus depreciation)
- Interest Income (Interest collected on loans, e.g. fix-n-flip loans)
- Capital Gains (Sale proceeds minus cost basis)

Qualified money (IRA/401K investors) usually like interest income and capital gains, and don't really care about the benefits of depreciation (or accelerated depreciation). Non-qualified money (non-IRA/401K) typically enjoys the depreciation benefits as they reduce taxable income.

Real estate professionals may greatly benefit from investments with accelerated depreciation as they can deduct "passive losses" against their current income.

Non-real estate professionals too might enjoy "passive losses" if they have "passive gains" from current income generating investments or sale of appreciated assets generating capital gains.

Broadly diversified funds may combine many assets that generate different types of income, while some other funds have a focused investment strategy generating only a single type of income. Generally speaking, having a good real estate CPA will make a big difference in helping you make the right investment decisions.

✅ ***Takeaway:*** *If this section sounds vague, it is – purposely. The point is to always talk to your CPA about the tax consequences of any investment. Most funds managers are not CPAs and should not give you tax advice. They should be able to explain to your CPA what assets the fund invests in and the likely tax consequences, but your CPA should be the best source of tax advice.*

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5. How liquid is my investment?

Most open-ended funds have a lock-in period during which any funds you invest cannot be withdrawn except for specific emergencies. The lock-in period for many real estate investment funds is at least two years. Some are shorter, and some are longer. Redemption may or may not be available even after the end of the lock-in period if there are adverse market conditions impacting the fund, e.g. COVID-19 or market conditions liquidity dries up.

Most close-ended funds have no redemption mechanism and so no liquidity until the fund completes its investments strategy and exits its assets. Normally, the fund manager will communicate the target investment time and projected exit time, e.g. 5-7 years. Some assets may exit sooner and some may take longer to sell. Market conditions could play a big role, obviously.

Fund liquidity is usually a function of the assets in which the fund invests. So, once the lock-in period has expired the liquidity of your investment — your ability to withdraw it — is tied to the liquidity of the funds. With funds that have short investment cycles, like lending on the short-term fix and flips, many times you can withdraw your investment fairly quickly. With funds that have longer-term investments, the process of withdrawing your investment can be longer.

Either way, when you request to pull out some or all of your investment, and the lock-in period has expired, if cash is not readily available from the fund, you are placed in a queue and your money is withdrawn when it becomes available.

With a close-ended fund, you may ask the fund manager to find another investor to "step into your shoes" if you need the liquidity. However, the new investor may or may not be willing to pay you the full value of your investment plus accumulated preferred return. Assuming there is a willing investor to take your position in the fund, It becomes a negotiation and typically requires fund manager's approval as well.

✅ ***Takeaway:*** *Know the lock-in period (open-ended fund) or fund life-cycle time (close-ended fund) for your investment, and be comfortable that the types of investments made by the fund coincide with your future cash needs should you need to pull some or all of your investment.*

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6.What are the fees?

Every fund has a fund manager and an admin staff or 3rd party fund administrator that needs to be paid to ensure the investment goals and the fund's target returns are being met, as well as to have the fund's financial books run properly, investor statements prepared and distribution payments are processed.

Some funds have a mandatory annual audit to give investors the full confidence of audited financials. Those fees are paid by the fund as operating expenses before any income is available for distribution.

Typically, fees can be classified as:

1. Management fees
2. Administration fees
3. Audit fees
4. Tax preparation and filing
5. Carried interest/performance fees
6. Asset acquisition fees

1.MANAGEMENT FEES

The basic fee for managing the fund, finding the assets and investing in them, and managing the existing fund portfolio. That fee can range from 0.5% to 3% of AUM ("Assets under management") annually, but are typically 1.5% to 2%. This fee is to "keep the lights on."

2. ADMINISTRATION FEES

Typically, a 3rd party fund administrator company charges the fund for bookkeeping, accounting, statement production and distribution. It ranges between 0.2% to 0.5% of AUM annually, but usually isn't more than that. The bigger the fund the lower is the Administration fees ratio.

3. AUDIT FEES

Typically, if required by the fund's Private Placement Memorandum (offering document), then a 3rd party auditor must be engaged to complete an annual financial audit.

The fee is typically not linked to the AUM, and is negotiated depending on the amount of assets in the fund and the number of investors.

4. TAX PREPARATION & FILING FEES

The tax and accounting fees are imposed by a third party administrator and are not controlled by a fund manager.

5. CARRIED INTEREST/PERFORMANCE FEESS

When a fund performs above the Preferred rate of return ("Pref"), the manage-ment is rewarded with a share of the earning that exceeds the Pref. That can range from 20% to 50%, typically, and is only paid once Preferred return is paid.

6. ASSET ACQUISITION FEES

Some funds charge asset acquisition fees to compensate fund management for identifying and underwriting deals, e.g. 1% of the invested capital.

✅ ***Takeaway:*** *There must be an alignment of interest between fund managers and investors through the carried interest/performance fees. Standard fees (Mgmt, Admin, etc) are necessary to enable a successful operation of the fund.*

7. What is the fund manager's experience?

Fund managers' experience, deal generating network, and the ability to execute a successful investment strategy can make a huge difference in the returns of the fund.

Talk to the manager. Have the manager explain the philosophy used in managing your investment. Understand the manager's career, the types of assets in which the manager has had success, the track record of returns, and the management experience.

Takeaway : Make sure that you KNOW, LIKE and TRUST the fund manager. Integrity, trustworthiness, transparency, excellent communications, strong investment experience and conservative investment philosophy are some of the key elements of the successful manager profile.

8. How does the manager determine which assets to invest in?

Good fund managers should be able to clearly articulate where they source the deal-flow, their underwriting criteria, and their deal selection process. Best managers operate with the overall blue-print. They build a fund like they build a house: with a plan.

Successful managers have developed long-term relationships through networking, associations, and repeat business. Good fund managers gravitate to good project sponsors who have successfully completed many real estate deals within the parameters of the fund PPM.

Takeaway: *The best manager finds assets through long-term relationships with successful project sponsors.*

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9. What's the difference between open-ended and close-ended funds?

An open-ended fund (a.k.a. evergreen fund) continues to raise new money from new and existing investors, redeem selling investors, and make new investments without a specific exit date. Subscriptions and Redemptions are on a periodic basis such as quarterly.

Open-ended funds generally have better liquidity than close-ended funds.
One of the major complexities of an open-ended fund is the need to "mark to market" all assets for each subscription point. This determines the price per Unit/Share. Distributions from open-ended funds may be re-invested.

A close-ended fund raises capital for a specific amount of time, e.g. 1-2 years ("Capital Raising period"), executes its investment strategy during a specific period of time, e.g. 1-3 years ("Investment period"), and then holds all assets through their life-cycle until the exit point - it has a finite life such as 5-7 years.

Typically, close-ended funds must pay full "Pref" (catch up on the underpaid Pref as needed), then return all the investor capital, and then split remaining income according to the performance split, e.g. 70/30 or 80/20. Distributions from close-ended funds may not be reinvested.

Close-ended funds don't need to "mark to market," making it easier to manage. One of the major limitations of close-ended funds is the lack of liquidity. Investors must be patient for the life of the fund as there is no redemption mechanism in general. The only way to redeem an investor is to find someone who is willing "to step into their shoes," and requires the approval of the manager.

Finally, most the close-ended funds work on capital pledges or commitments (subscription is a pledge to invest) and capital calls (time to wire in the capital to go to work on a deal). The fund doesn't keep idle money in the bank. Instead the fund manager calls in the required capital from the pledges to fund an upcoming deal.

✅ ***Takeaway:*** *Most real estate funds are close-ended. Traditional long-term investments are made through close-ended funds. However, open-ended funds do come into play providing generally better liquidity, but are more complex to run.*

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10. What are the pros and cons of investing into a fund vs. an individual deal?

Advantages of investing in a fund:

1. Instant diversification — you are investing in a variety of projects instead of just one
2. Better access point - fund managers negotiate better terms by writing bigger checks
3. Passive income - you enjoy the benefits of a passive investment
4. Take advantage of the fund manager's experience and network
5. Potentially better liquidity if the fund is open-ended

Disadvantages of investing in a fund:

1. You have no control over the deal - you ride along the decisions of the fund manager
2. Various fund fees may impact returns

✅ ***Takeaway:*** *While there are some inherent costs to invest in real estate funds, for most investors, the hands-off aspect, the experience of the manager, and a well-diversified portfolio make it a smart choice.*

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