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Real Estate Finance Challenges in the Wake of the Recession—The Case for Private Equity Funds

By Jeffrey J. Wild and Jacob Fleischmann

Current Market Factors. The U.S. commercial real estate market remained relatively flat in 2011, due in part to the continued caution resulting from the volume of commercial real estate loans that are scheduled to mature in the near and mid-term (which are estimated to be approximately $1.4 trillion by 2013 and $2.5 trillion by 2019) and the depressed real estate values relative to the amount of that debt. Given this environment, the demand for commercial real estate financing from traditional lending sources has dramatically increased, as owners and developers of commercial real estate seek capital to fund improvements required as a result of new or restructured leases at their properties and/or to refinance maturing or already matured loans. Banks and other traditional lending sources have responded. The Mortgage Banker's Association, in its inaugural forecast for commercial/multifamily real estate finance markets, projects that origination of commercial and multifamily mortgages will hit $230 billion in 2012, an increase of 17% from 2011 volumes, and will continue to rise to $290 billion in 2013. Jamie Woodwell, the Vice President of Commercial Real Estate Research for the Mortgage Banker's Association, stated that "Our forecast anticipates continued strength in lending by life companies and the GSEs, increased lending by banks and others, and a slow but steady return in CMBS activity. Low loan maturity volumes over the next few years, coupled with moderate sales transaction activity, will mean that a relatively robust supply of mortgages will be a catalyst for deal activity."

Despite the increased liquidity in the commercial real estate markets as commercial real estate lenders improve their balance sheets, lenders remain selective over the quality of the real estate assets they are willing to finance, and underwriting standards remain fairly strict. As traditional commercial real estate lenders cherry-pick the best credit quality deals, many property owners and developers seeking capital are looking to other sources to fill this need, and private equity is one such source.

Notwithstanding the perceived level of "distress" in the commercial real estate markets that still persists, the stabilizing of the commercial real estate market has served as a catalyst for investment. According to Preqin Ltd., a London-based private equity research firm, 114 real estate private equity funds closed in 2011 having raised more than $44 billion, and there are currently 450 funds out on the market seeking an aggregate of $165 billion.

However, despite the interest in private equity investment in commercial real estate, private equity funds seeking to raise capital still face significant challenges in their efforts to attract investors. There is still a good deal of uncertainty over the direction of commercial real estate values. Additionally, private equity funds face stiff competition from REITs, which traditionally have

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lower management fees, are more transparent, provide greater investment liquidity and have generated significant returns for investors as an asset class in the last few years. Finally, private equity funds must now grapple with the Dodd-Frank Wall Street Reform and Consumer Protection Act passed into law in 2010, including the "Volcher Rule," which prohibits any "banking entity" from engaging in proprietary trading, or sponsoring or investing in a hedge fund or private equity fund (subject to certain exceptions). This is problematic for private equity investors, because it will significantly limit funding options. Moreover, Dodd-Frank's new requirements will bring private equity funds under the auspices of the Securities and Exchange Commission (SEC). Any entity that has assets of at least $150 million is subject to record-keeping and disclosure requirements pursuant to the SEC and the Commodity Futures Trading Commissions (CFTC).

Market Structure for Private Equity Funds. There is a wide range in the size and scope of private equity funds, from the mega funds with billions of dollars of assets that are managed by international private equity firms, to the local developer-managed funds that might have $10 million or less in capital. Similarly, the investment strategy of private equity funds also varies widely, where funds will identify a target asset type, such as office, retail, multi-family or industrial, and the type or types of investment that the fund is willing to make. Typical investment categories include, among others: (i) co-investment or joint ventures with other equity funds in target assets, (ii) structured finance or leveraged buy-outs, characterized by the use of debt and equity to acquire higher quality assets, (iii) acquisition of or investment in distressed assets, which may include the purchase of distressed loan portfolios, and (vi) development, where the fund itself intends to undertake a development project.

Private equity funds typically raise capital from a variety of sources, which range from large institutional investors to "friends and family" money. Large institutional investors typically look to funds with assets in the $100 million plus range, while not surprisingly, friends and family investors are major contributors to smaller funds. However, given the shedding of real estate assets by institutional investors over the last few years and the recent growth of sovereign wealth funds, all types of private equity funds will likely see significant investment from these sources as institutional investors seek to rebalance their investment portfolios and sovereign wealth funds seek to deploy their considerable assets.

The economic features of private equity funds, including start-up costs, fees and expected returns, vary from fund to fund, however, the following features are more typical in recent private equity funds:

- The start-up costs (i.e., legal fees, accounting fees, printing costs, etc.) for a private equity fund are traditionally between 2% and 5% of the capital raised by the fund.
- The capital investment by the party organizing the fund, also known as the sponsor, varies depending on the fund, however, institutional investors will typically require that sponsors have at least 5% to 10% of the fund represented by their own capital.
- Fund managers, which are typically the sponsors, earn an annual management fee between 0.5% and 2% of the capital invested, although the industry standard appears to be between 1.50% and 1.74%.
- Investors expect a preferred return of 8% to 10% annually.
- Once all of the investors have been repaid for their initial capital investment and any accumulated preferred returns, excess earnings are typically split 80/20 or 70/30 between the other investors and the fund sponsor, although this can vary depending on the fund history and prior successes.

Legal Considerations

The Fund's Perspective. Soliciting investment by domestic private equity funds and the operation of the funds are regulated by Federal securities laws, including the Securities Act of 1933, the Securities and Exchange Act of 1934, the Investment Advisors Act of 1940 and the Investment Company Act of 1940, in addition to any applicable State securities laws. Federal and State securities laws typically require that securities offered for sale to the general public be registered with the U.S. Securities and Exchange Commission, which is a costly and time-consuming process, and involves detailed reporting requirements once the securities are issued and sold to the public. There is, however, an exemption for securities offerings that are conducted as a "private placement," where there is no general solicitation or advertising of the securities, and the securities are sold to "accredited investors," which primarily include individuals having a net worth of at least $1 million or a regular annual income of at least $200,000 ($300,000 when combined with a spouse) and business organizations with assets of at least $5 million. The private placement exemption allows private equity funds to solicit investment from accredited investors with whom the fund sponsor has had a preexisting substantive relationship through offering materials known as a private placement memorandum.

The Fund Investor's Perspective. Private equity funds are typically formed as limited liability companies or limited partnerships under applicable State law. Accordingly, it is important that the investor receives and reviews the organizational documents in addition to the private placement memorandum and other offering documents when considering investment in a private equity fund.

Additionally, private equity funds are structured as "pass through" entities with respect to income tax, which means that the tax attributes of the fund are passed through to the individual investors and become part of the investors' taxable income. Given the complexity of the tax rules regarding certain types of real estate investment, investors should consult their advisors to understand the potential impact on the investor's tax position that could result from investment in the fund.

The Target's Perspective. While the capital infusion a commercial real estate owner receives from investment by a private equity fund is likely welcome, and is most likely necessary for the continued viability of a real estate project, such investments come at a cost to the property owner and its principals. If an institutional private equity fund's investment in a real estate project involves acquiring an ownership interest in the entity that holds the real estate, the investment will likely be structured as preferred equity, where the fund receives a return on its capital investment before the other principals of the entity. Additionally, the investment may involve limitations on the original principals' control and management rights with respect to the operation of the real estate, where the private equity fund effectively obtains control of the entity or requires that the original principals must obtain the fund's consent to certain expenditures or actions concerning the real estate. These changes might be seen by the original principals as simply the cost of receiving the additional capital, without which the principals may have otherwise lost their investment due to a forced fire sale of the real estate or foreclosure by the mortgage holder. But in any event, the principals should carefully consider the practical effect that these changes could have on the operation of the real estate and the principals' return thereon post-investment.

In conclusion, despite the challenges and concerns that private equity funds, their investors and the individuals seeking their capital face, as discussed in this article, which is by no means an exhaustive list, the stabilizing of real estate values and the need for an alternative source of capital appear to suggest that private equity funds will play a substantial role in providing liquidity to the commercial real estate markets as they continue to recover.

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Ohio Hydraulic Fracturing Update

by Tamar Gontovnik

Regulation of Hydraulic Fracturing in the Marcellus and Utica Shale in Ohio

As the shale boom in Ohio continues, hydraulic fracturing continues to be one of the spotlighted issues. In light of the speed at which hydraulic fracturing is occurring in Ohio, and the associated public concerns, Governor Kasich recently signed an energy bill whose focus is on hydraulic fracturing. The new law makes many changes to Ohio's oil and gas regulations, which, in their current form, apply to oil and gas operations generally and do not necessarily account for issues specific to hydraulic fracturing.

The Current State of Regulation of Hydraulic Fracturing

Hydraulic fracturing and oil and gas operations are primarily governed by Ohio Revised Code 1509 (ORC 1509) and associated Ohio Environmental Protection Agency (Ohio EPA) and Ohio Department of Natural Resources (Ohio DNR) regulations. The Ohio DNR, Division of Mineral Resources Management, together with the Ohio EPA, have regulatory authority over the various aspects of hydraulic fracturing. In March of this year, the Ohio EPA released the *Guide for Operators Drilling in the Marcellus and Utica Shales*[1] (the Guide), which summarizes the current state of the laws and regulations as they apply to hydraulic fracturing. Some highlights follow:

- A permit from Ohio DNR is required to drill, deepen, reopen, plug back, convert or plug a natural gas, oil, Class II injection or enhanced recovery well.
- There are required notification and reporting requirements to Ohio DNR for all wells during cementing, well completion, stimulation and production. A driller is required to report information on the type and volume of produced and injected fluids.
- If a facility or combination of facilities has the capacity to withdraw water at a quantity greater than 100,000 gallons per day (about 70 gallons per minute), it must be registered with the Ohio DNR. Because of the Great Lakes–St. Lawrence River Basin Water Resources Compact, Ohio DNR will not issue permits for oil and gas operations for the transfer of water out of the 33 counties located in the Lake Erie Basin.
- Air emissions permits may be required from Ohio EPA for certain activities including dehydration systems, natural gas-fired and diesel engines, unpaved roadways, petroleum liquids and recovered water storage tanks, natural gas-fired turbine generator sets, combustion devices/flares and equipment/pipeline leaks.
- If construction of a drill site will impact wetlands, streams or other waters of the state, drillers must obtain approval from the U.S. Army Corps of Engineers and Ohio EPA.

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Ohio Hydraulic Fracturing Update

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- Ohio DNR requires drillers and operators to implement best management practices (BMPs) for sediment and erosion control as part of their drilling authorization permit in urban areas.
- Ohio does not authorize the disposal of brine at municipal wastewater sewage plants (POTWs). Brine disposed of in Ohio must be sent to an ODNR-permitted Class II injection well, unless granted an exemption by ODNR. Transporters of drilling-related fluids must register and receive an identification number, maintain a daily log and submit an annual report to ODNR.

Energy Bill Proposes Changes to Hydraulic Fracturing Regulations

Into this regulatory environment, Governor Kasich released Ohio Senate Bill 315 (Bill 315) on March 22, an energy bill whose focus is regulation of hydraulic fracturing.[2] The bill was revised, approved by the Ohio Legislature and signed by Governor Kasich on June 11, 2012. Bill 315, now law in Ohio, is an effort to revise Ohio's laws to account for horizontal drilling and hydraulic fracturing technologies.

The new law addresses issues that have recently received much press and public attention, including deep well injection of wastewater and accusations of groundwater contamination of private wells. In response to concerns, Bill 315 codifies to codify some of the guidelines established in the "Best Management Practices For Pre-Drilling Water Sampling," published by the Ohio DNR in 2005, including the recommendation for pre-drilling sampling all water wells within 300–1500 feet of the proposed horizontal well. In addition, Bill 315 modifies regulation of deep well injection as a means of disposal of wastewater and brine. Here are some highlights from Bill 315:

- A new application for a horizontal well (Application) will require a Road Use Maintenance agreement with local government(s) concerning maintenance of roads, streets and highways.
- An Application must identify each proposed groundwater or surface water source for the production of the well, and the estimated rate and volume of water withdrawal for production operations.
- An Application must provide the baseline sample results of all water wells within a certain distance of the proposed well prior to commencement of drilling.
- The owner of a horizontal well must obtain at least $5 million in liability insurance coverage, and the insurance policy must include a reasonable level of coverage available for an environmental endorsement to cover any pollution and contamination occurring as a result of the drilling, operation or plugging of the owner's wells.
- The owner of the well must disclose all chemicals used and the amount used during the drilling process and during hydraulic fracturing; however, the owner can designate chemicals as trade secrets. Chemicals designated as trade secrets may not be disclosed by the Ohio DNR.
- Upon request, the owner of a well must provide to emergency responders the exact chemical composition, including the identification of each proprietary component, of each fluid used in the drilling, stimulation, servicing, operating and plugging of the well.
- Bill 315 increases disposal fees and includes new regulations governing oil and gas injections wells.

Bill 315 also gives Ohio DNR the power to promulgate rules relating to horizontal wells and their production facilities and directs Ohio DNR to promulgate regulations governing the disposal of brine in Class II injection wells. Benesch will continue to monitor legislative and regulatory developments related to hydraulic fracturing and horizontal drilling.

[1] The guide is available here: http://epa.ohio.gov/LinkClick.aspx?fileticket=MtPaJfql1XA%3D&tabid=5339.
[2] Bill 315 is available here: http://www.legislature.state.oh.us/bills.cfm?ID=129_SB_315.

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New Smoking Law's Impact on Property Owners

by David E. Kress

As has been widely reported in the media, the State of Indiana recently passed a non-smoking law. The State's law was effective July 1, 2012.

The new State law (Indiana Code 7.1-5-12) prohibits smoking in "places of employment," "public places" and areas within eight feet of an entrance to such a place. This essentially includes all enclosed areas where people are employed, but excludes private vehicles. A "public place" is "an enclosed area of a structure in which the public is invited or permitted." Therefore, a commercial property owner with multiple tenants will be covered by the law and will need to comply.

The law further requires an owner of a place of employment to remove all smoking paraphernalia (e.g., ashtrays) from the premises, and to post public signs at each public entrance that read "State Law Prohibits Smoking Within 8 Feet of This Entrance" or other similar language. A party who violates the law is subject to a fine up to $1,000, increasing to a penalty of up to $10,000 if the employer has previous violations.

The Indiana Alcohol and Tobacco Commission has created signs that an employer or property manager is required to place outside public entrances. (http://www.in.gov/atc/files/Smoking_8_Feet_Entrance.pdf). If a property owner has a tenant that refuses to post a sign, it is suggested that the property owner post the sign. A property owner may be able to charge the cost to the tenant depending on the language of the parties' lease.

The full text of the new state law can be found at http://www.in.gov/legislative/bills/2012/HE/HE1149.1.html.

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Get to Know **Jeffrey J. Wild**

Who: **Jeffrey J. Wild** is a partner and Vice-Chair of Benesch's Real Estate & Environmental Practice Group. He focuses his practice on commercial real estate matters, with a focus on financing, leasing, acquisitions, dispositions and development. He has extensive experience in the negotiation of all types of development and financing documents

What Jeff wants you to know about the Real Estate Industry: Although there is still instability in the market and cap rates are still aggressive relative to historical standards, financing has become more readily available (especially for quality projects) and more product is becoming available for acquisitions.

When Jeff is not practicing law: He is being active with his wife, Danielle, and their three boys, Joshua, Zachary and Aidan. He spends a lot of time wondering what it would be like if he remained a New York sports fan rather than converting to an Indians, Cavaliers and Browns fan!

Recent Client Engagements

- Represented a large public REIT in the acquisition of an approximately $50 million shopping center in Illinois.
- Represented an investor group in the acquisition and financing of a grocery-anchored shopping center in southwest Ohio.
- Represented a private equity group in fund formation, acquisition and financing matters in connection with multifamily property acquisitions throughout the Southeast.
- Represented a client in the making of a $12+ million mezzanine loan secured by a pledge of membership interests in an entity that owns a large retail shopping center.
- Represented a Fortune 500 company in connection with the sale, leaseback, financing, development and construction of the company's world headquarters building, innovation center and adjacent parking facilities.
- Assisted in the re-leasing of an outlet shopping center that was affected by a major casualty event. Such efforts included finalizing hundreds of new leases and amending the leases of existing tenants.
- Represented a bank client in connection with a loan to a developer to construct a build-to-suit distribution facility for a subsidiary of a Fortune 100 company.

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News About Us

- **Kevin Margolis** was elected as a Fellow to the American College of Real Estate Lawyers (ACREL), making him the eighth ACREL Fellow from Benesch's Real Estate Practice Group. ACREL is a prestigious and highly selective national organization of real estate attorneys recognized for their skill, experience and high standards of professional and ethical conduct.
- Real Estate partners **Jeff Abrams, Norm Gutmacher, Jim Schwarz, Howard Steindler** and **Jeff Wild** were again named Leaders in their Fields by *Chambers & Partners*.
- **Courtney Kanzinger** was appointed to the Board of Directors of Child Advocates, Inc. (CAI). CAI is a private non-profit organization that mobilizes Court Appointed Special Advocate volunteers to break the cycle of child abuse in Marion County, Indiana.
- **Jeff Wild** was appointed to the Board of Directors of Cleveland Development Advisors (CDA). Established in 1989, CDA provides resources as well as local knowledge and professional expertise—collaborating with developers, financiers, and community stakeholders to structure the financing of important, catalytic projects in Cleveland.

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