Are Small Real Estate Funds Better?

For several years, bigger has been better when it came to real estate funds. The opportunities to control rental markets and buy up large blocks of REO and distressed properties usually meant that the funds had to be big. Also, economies of scale, higher-quality management, and the spreading of fund expenses over a larger base of assets contributed to improved performance. Smaller funds have been finding some advantages that emerging managers may want to consider. **Real estate owner/operators with auditable track records may want to consider developing a private funds business as a financing source for their growth or exit strategies.**

Large funds have had trouble placing capital with nearly $250 billion of dry powder reported. These large funds have been reluctant to continue raising capital until they find new pipelines for property acquisitions. While properties are available, buyer competition has driven prices for large properties up. At these prices, it becomes difficult to meet investor return expectations. Most large funds have been unwilling or unable to drop their minimum acquisition price and continue to look for reasonable cap rates in larger properties or hunt for portfolios of properties that can be purchased as a single transaction. This opens the door for better pricing on properties below this minimum size.

While large properties have been mostly overbought, value still exists in properties priced under the levels targeted by large funds and above the levels the mass affluent can afford. The difficulty has been in raising capital for these opportunities. Large operators have institutional investors, but mid-sized operators without a history of fund operations get left out of these allocations. Smaller real estate funds may be a good funding source for many of these mid-sized operators who still produce above average returns on their real estate investments.

These smaller real estate funds are filling a need with investors as well. The independent broker dealers and RIAs have had difficulty finding real estate product for their clients. The big funds have reserved their limited capacity for their large institutional clients, and, historically, the smaller funds tend to have investors that go directly to the fund and bypass intermediaries who distribute or recommend such products. For smaller funds that use the independent broker dealer channels and RIAs for distribution, the availability of capital can help build a robust fund business.

If a real estate pullback is coming, dry capital will again become an advantage as opportunistic investing becomes the strategy of choice. Those owner/operators that have experience launching smaller real estate funds should have an advantage in raising capital to acquire these deeply-discounted properties. As their fund business grows, so will the IRR of their own equity investments in real estate. Their equity becomes the seed capital for the funds, and returns are enhanced by fees paid to them as the fund advisor and general partner.

Contact Richard Jenkins of Stone Toro, LLC to find out about the current advantages of launching small funds.

Richard Jenkins, CEO
Stone Toro, LLC
richard@stonetoro.onmicrosoft.com