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An Insider's View of Fund Management

Here's an overview of what you need to know if you plan to launch your own fund—or if you're just curious about how funds work.

by Cort Chalfant

This is the first in a short series of articles about the practical aspects of fund management. There's a lot to cover, but the goal is to give you a foundation you can build upon. Nexus Private Capital launched its current fund more than three years ago, in March 2017, and it has grown to approximately $36 million of investor capital.

A short list of high-level concepts you should consider when forming a fund includes:

- **Being a manager—not just a deal junkie.**
- **Barriers to entry—they do exist!**
- **Fund structure.**
- **Leverage.**
- **Attracting capital.**

This list is not exhaustive. Each item includes myriad finer points. Plan to dig deeper into each of these points before you commit to your own business plan.

MANAGEMENT CONSIDERATIONS

In the old-school model of private loan originations, one or a handful of investors would fund each note, and each investor would be named in the deed of trust or collateral instrument securing the loan. This approach covers the vast majority of private originations historically. But, these investors suffer from a lack of diversification, and the mechanics of rapidly funding loans and managing foreclosures can be problematic.

An investment fund is great for solving these problems, but *management,* rather than simply deal flow, becomes the key success factor. To be successful as a fund manager, you must be operationally sound and have an especially strong resume.

You will need to have a highly disciplined focus on formal processes such as fund servicing, accounting, reporting, and managing people rather than on just the deals.

Trust, ethics, and track record will become your new currency, because investors generally don't like to go into a blind pool governed by nothing more than fund documents and faith. You can mitigate these reservations by bringing proven talent into the company at the senior management level or by establishing an advisory board or formal board of directors. It will also help if you establish checks and balances for how cash is handled and decisions are made.

At the end of the day, there is no fail-safe mechanism to prevent a fund manager from taking off with the cash. More than anything else, this is why management must have a collective resume that unquestionably builds confidence.

BARRIERS TO ENTRY

Fortunately, or unfortunately, depending on your stage of fund life cycle, there are barriers to entry. It is not uncommon to spend $50,000 or more on the preparation of fund documents, which consist of the private placement memorandum, operating agreement, and subscription agreement. You also will need to invest in office space, technology, a website, and people—unless you are a multitalented prodigy who already possesses specialty skills in fund accounting, fund servicing, loan servicing, business development, investor relations, and law.

Finally, don't forget about your annual audit, preferably prepared by a firm sporting the Public Company Accounting Oversight Board (PCAOB) certification. This assumes, of course, that you want to give your investors peace of mind or you intend to seek institutional capital. Our first annual audit cost $55,000. We have since reduced the cost to the $20,000 range.

FUND STRUCTURE

Take time to thoughtfully parse through alternative fund structures. Then build a financial forecasting model that measures revenues to the manager and investors, respectively, based on various assumptions about key activity drivers such as loan originations, subscriptions, and redemptions.

Deciding whether your fund is "open" or "closed" may dictate whether you need systems for calculating daily share prices. The structure will also shape policies for admitting or redeeming member subscriptions.

Your choice of fees the manager is entitled to versus the sources, as well as priority and timing of distributions to investors, will define the ultimate risk-return profile of your offering. Importantly, your fund

structure will establish and project the extent to which the interests of manager and investors are earnestly aligned.

As a generally rule, you will find that managers keep a number of fees entirely to themselves (e.g., loan origination, extension and late fees, and a share of the interest coupon generated by loans). In addition, it's not uncommon for managers to charge asset management fees equal to half a percent to 1% of assets under management (AUM) plus fees for fund servicing and/or loan servicing that could equal another half a percent to 1%, each.

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Under these arrangements, it's not uncommon to see targeted payouts to investors in the 7%-8.5% range, but there are also examples as high as 10%–11%. Differences often come down to the size and track record of the fund, average loan sizes, the quality of collateral, and/or the types of property financed.

Much more could be said about alternatives to the structure outlined above, but it is the most common. However, it is not the form we've adopted. An argument can be made that the traditional approach falls short of adequately aligning the respective interests of manager and investor. We'll address the alternatives in future articles, describe why this traditional approach can fall short, and explain why we chose an alternative form for our fund.

LEVERAGE

The degree to which a fund is designed or permitted to use leverage is another important consideration. Like many other tidbits that are hard to pin down in the highly fractured, mostly privately held and closely guarded industry of private lending, you will find conflicting information about the extent to which funds use leverage.

It does seem safe to say, however, that most funds have the ability to use some level of leverage, and it is not uncommon to see a 1-to-1 ratio of debt to equity. The issue to consider here, of course, is fear and greed: fear investors will feel from having their capital subordinate to a bank if things go bad and greed that may

tempt you to overly weight toward this cheaper source of capital (currently in the 5½% - 6½% range) to juice your returns.

A secondary, but equally important, consideration about leverage relates to what happens to your business model when markets seize and credit facilities get called—as they did when COVID-19 hit and during the 2008 market meltdown.

ATTRACTING CAPITAL

Raising capital is big lift. As noted, investors tend to not like investing sight unseen, and they will demand impeccable management resumes. To successfully launch your fund, more than likely you will need a stable of friends and family to seed your offering. You should plan to contribute a significant chunk of your own capital as well. Your contribution doesn't have to be huge, but it should be painful to you if you lose it. It also helps if you subordinate your capital to those of your investors as a way to demonstrate your commitment.

Beyond friends and family, you will need to solicit investments from people you don't know. If you organize your fund through SEC securities registration exemption 506c, then you can generally advertise your fund to "accredited investors," subject to a serious duty to verify the accredited status of each. Organizing under registration exemption 506b will shift the burden of verification to the investor, but it will limit the extent to which you can promote your fund.

If yours is a small fund (under $50 million) or you can't point to a three-year track record supported by ideally PCAOB-certified annual audits, then don't waste your time approaching institutional sources of capital or even family offices. Although exceptions can be made if you are an exceptionally well-known commodity within their circles, institutions generally won't look at you if your AUM is less than $100 million.

Similarly, family offices will have trouble overcoming control issues and will be conflicted by not wanting to invest less than $5 million but not wanting to be more than 10% of your assets. For these reasons, during the early stages of your fund, time is likely better spent focusing on individual accredited investors that you can source from your existing sphere of influence and/or from angel networks.

Invariably, your best source of investors will be existing happy investors. The yield-hungry public has few choices that can match the outstanding combination of yield and safety that a diversified, professionally run fund of well-secured loans can offer. For that reason, and after you prove yourself, they will refer friends and reward you with follow-on investments.

As an added tip, be sure to offer your investors a reinvestment option. That way your fund will grow each month from reinvested earnings alone. ●

ABOUT THE AUTHOR

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Cort Chalfant is the manager of Nexus Private Capital. He is a seasoned executive in multistate real estate acquisitions, asset management, leasing, development, and commercial debt transactions. He has a demonstrated track record of managing and directing a diverse range of real estate projects and affiliate operating companies.

Chalfant's core competencies are synthesizing complex business opportunities, threats, resources, and conditions into winning strategic plans; financial underwriting; and mentoring high-performing teams. He is a skilled negotiator of legal contracts, leases, ordinances, and agreements and has a solid understanding of mortgage and capital markets, syndications, and capital formation.

Before his tenure at Nexus Private Capital, Chalfant was vice president of Coast Range Investments, senior vice president of the Rancho Sahuarita Companies, and an acquisitions and asset manager at the Holualoa Companies.

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