EPISODE 366

[INTRODUCTION]

[00:00:00] ANNOUNCER: Welcome to The Real Estate Syndication Show. Whether you are a seasoned investor or building a new real estate business, this is the show for you. Whitney Sewell talks to top experts in the business. Our goal is to help you master real estate syndication.

And now your host, Whitney Sewell.

[INTERVIEW]

[00:00:24] WS: This is your daily Real Estate Syndication Show. I'm your host, Whitney Sewell. Today, our guest is Steven O'Brien. Thanks for being on the show, Steven.

[00:00:32] SO: Thank you for having me.

[00:00:33] WS: Now, I'm honored to have Steven on the show. He is a perfect guest for the show with his experience and his company's experience. They have been in this business for a long time, and he has lots of expertise that he's going to share with us today that I know you are going to find relevant in your business and things you need to know.

But first, I want to remind you to go to Life Bridge Capital. Go to the contact us page and connect with me. So we can get on the phone, schedule a call with you, and happy to help you any way that I can. Go to Facebook group, the Real Estate Syndication Show where you can leave questions for guests and experts just like Steven. So we can get your questions answered. Go there and get active in the group.

But a little about Steven O'Brien, he is the co-founder and chief investment offer of Arcan Capital, was responsible for the identification, acquisition, management, and reporting of over 25 multifamily assets totaling over $300 million in value. He secured the placement of nearly 200 million in financing [inaudible 00:01:30] bank and insurance company sources. So Steven, thank you so much for your time and sharing with us today on the show. Give us a little more about who you are in the company and even where you're located, and let's jump in to this topic that I know everybody wants to know about.

[00:01:46] SO: Sure. Yeah. Arcan Capital is the name of our company. We're based in Atlanta, in the north side of town. We focus on the southeastern United States, almost exclusively value-add apartment investing. We have been at Arcan Capital for about three years now, founded in mid-2016. But prior to that, my business partners and I have worked together acquiring multifamily since 2012, and I've been in real estate since 2006.

[00:02:12] WS: Would you share just like a minute or two-minute version of how you got into this business? I thought that was relevant to the listeners as well.

[00:02:21] SO: Sure, absolutely. I actually found my way into real estate because I was an analyst. So I started with CBRE doing financial analysis in Excel models, ARGUS, which is not really pertinent to multifamily. But ARGUS is one of those real estate software tools for office and retail and hotel that's used in industrial. So I got started there and gradually built up my expertise into a point that the right opportunity presented itself to get on the principal side where I always wanted to do some investing. That was my foot in the door, for lack of a better term. So I found my way in through my Excel knowledge and analysis ability and was able to transform it into roles of principal.

[00:03:02] WS: Now, that's great. I love stories like that because people are – I mean, I get so many calls every week that says, "Whitney, how do I get into this business. How do I get started?" So I hear different ways people got in. But more times than not, you develop some type of skill, so you can add value to some other teams, somebody that was doing this already. Underwriting in Excel is a great skill to have in this business. So, yeah, you said you built your own model I think and were very proficient at it.

But our topic for today and something you're well-versed in is what you all are doing at this – In the market cycle right now. This end of the cycle, how are preparing for this? What do think is happening and what you all are doing to prepare for whatever might be coming. So it's a very relevant topic, and I love that you wanted to talk about that and elaborate how you all are preparing for this.

But get us started a little bit on – Obviously, you are a value-add company. What are you doing to prepare for this possible or potential downturn that everyone is talking about?

[00:04:00] SO: Yeah. I think the reason it's so pertinent is, as you said, everybody's talking about and everybody's starting to talk about it. In fact, it was funny. I was recently in an event where they were talking about they were getting tired of talking about what inning we were in. So if you go back to even '16 when we founded our company, we thought the cycle had a lot more legs left to it. But there were a lot of people in 2016 that thought we were near the end, and there was a lot of data that pointed to it.

Now, we actually do believe we're getting closer to the end of this cycle, and we would say that we are approaching or are in the ninth inning already for a number of reasons. But what we think the best way to do or the best things to do to prepare for that in the end of the cycle is largely involving investors, regarding syndication. Then we found that when your investors understand what's going on in the market real time, you can set expectations. Then you could deliver on those expectations, because case in point when I got started in real estate in 2006. 2008 and '09, if you were buying real estate and getting 5 or an 8% return that you bought in 2007, '08, '09, people were pretty darn happy.

So it's always about what the expectation is in the market. The challenge for us today is returns have been so good for so long that we're finding it's taking some time to get back to the investors and get them prepared for the fact that those 25, 35 IRRs are probably going to start coming down. As cap rates are compressing and a lot of the returns are compressing, the investors are going to feel that. There just aren't quite as many of the lucrative deals out there. In our opinion, as prices go up and rent growth is starting to slow, it's still there, but it's starting to slow. I step number one for us is really preparing our investors and talking to people about the change on the market.

[00:05:46] WS: I love that. I love how you're talking about preparing the investors. I think when you are educating them about the market, all of a sudden when you have to explain why the returns, you're projecting smaller returns or lesser returns, it's easier to understand why that's happening, right?

[00:06:03] SO: Absolutely. You got to keep in mind most of our investors. I think most of the investors out there, very few people only invest in real estate. So one of the things that it's important to be aware of and prepare them for is a lot of the people that I talk to that are investors in equity markets, they also think things are overpriced. So it's not a story that's just confined to real estate. It's something that as you get out there and you communicate with your investors and you can come up with new strategies for ways to make people money. Even changes in the model of how you raise it and how you deploy it.

[00:06:31] WS: Okay. So what are some tips for how you all have prepared your investors for that?

[00:06:36] SO: We try and keep in constant contact with our investors. So one of the things we do is we have monthly reports and quarterly reports. We also have a newsletter that we are preparing to launch. So I think the key thing is if you stay in constant contact with your investors, you’re almost reminded to update them as things are happening, whether it's via phone or even a quarterly call or a monthly call so that they can get real-time data from what's happening on the property.

For us, because we are a property manager, we can give very accurate real-time data to the here's how many applications we got this week or here's what the lease rates are doing this week. Those changes and those numbers is as rental rates start declining or as you're getting less and less traffic, that's very quickly going to reach the bottom line and change some of the returns. So those are the things that we do. Reporting is an important function of our process.

[00:07:27] WS: Okay. So educating the investors and reporting, letting them know what's happening, whether it’s phone calls, monthly or quarterly reports. What are some of the next steps?

[00:07:36] SO: I think the other thing that we really focus on is debt, and that's one of the things that obviously was a big buzzword and everybody was very worried about at the end of the last cycle. I think that's a lot healthier now than it was in 2006, '07, '08. But that doesn't mean that we aren't starting to see loan, the values go higher. Having some flexibility with your lender I think is tremendously important, whether that's lower prepayment penalty. A lot of this is stuff you need to think about on the front end. It does cost you a little bit more to get some prepayment flex ability on the loans. But in a time when you've got to execute and you've got to move quickly, it's very valuable to have that flexibility.

[00:08:14] WS: So are there any other kinds of flexibility in the loan that we need to be thinking about that you didn't mention? Or maybe go over those again. Just things that, "Okay, this is important to have in this loan or this type of debt to make sure that we're prepared.

[00:08:27] SO: Sure. It also depends on your lender. If you have a – A lot of value-add properties that we've done, Fannie Mae, Freddie Mac, or HUD, they wouldn't lend on the property because it needs a lot of work or because it wasn't quite occupied enough. The bridge loans, while they are a great tool, they allow you to get higher leverage. If you're going up to 85% of the cost of the deal, you better be sure that you're going to create some value or at least have the flexibility with your lender, a good relationship with your lender.

Again, back to communication with lender as well, we found that if your lender understands step-by-step what you're doing and where you're hitting your goals and where you're not, they're a lot more flexible than if you just call them one day and say, "Hey, we got a problem."

So I would put and I hadn't even thought about that, but that relationship with the lender in some time, in some cases, is just as important as the relationship with the investor.

[00:09:14] WS: I appreciate you saying that. I wanted to go back to the first thing. I wanted to ask too like maybe the responses that you all have seen in this first step of – I want to go back to contacting, educating the investors and something I thought of when – If you all are projecting a lesser return because of a potential downturn, maybe give us an example of how you're explaining that to an investor.

[00:09:35] SO: Well, specifically even right now, it could also be in a change of strategy. So as I've mentioned, a lot of the equity we are syndicator, but we've also done funds. Right now, one of the ways that we're communicating to our investors is we're raising a fund. The fund that we're raising is focused on what's coming next, the opportunity that we see, because the problem that we're having now is we're not seeing enough opportunities to keep our investors happy.

So the way that we're communicating with them is through a new vehicle to say, "Hey, this is what we're seeing. This is how we'd like to raise money now." Maybe it's not today or by the end of 2019. But we do believe that as some of the things change in this market, there's going to be a great opportunity to buy assets. So that fund is a great way for us to continue the communication while also raising money from investors in a slightly different way and with a slightly different strategy.

So sometimes, the communication becomes self-evident in what you're seeing in the market, because right now my biggest complaint for my investors is, "Hey, when's your next deal coming?" Unfortunately, in 2013, we wanted to buy everything we saw in 2016. It was harder, but we still wanted to buy a lot of stuff. Right now, I mean, it's like 1 in 100. Every time you see a deal, there are other people out there really competitive and they're competing with you. So everybody sees a good deal, and you descend on it. Before you know it, the prices have raised enough because it's a competitive bidding environment where it's too expensive and it's not as good of a deal as it was when you first identified it.

So there are number of ways that we do that, and I think the change in strategy from how you're raising your money and exactly how you're deploying it can be a very helpful way to communicate with the investors what you're seeing in the market and how to adjust your strategy to raise the funds.

[00:11:18] WS: That's interesting. That's a great strategy. Then you're going to have that capital available when you need it. So you're educating the investors and you talked about the debt. Is there another step after that?

[00:11:27] SO: Yeah. I think beyond that, it's having a actual market strategy, which is it's funny to say. But you get so caught up in, "I'm a value-add apartment investor. This is what I'm going to go look for." For instance, we saw a deal recently that was new construction delivered in

2017. When we started comparing the returns, we kind of slapped ourselves in the head and said, “Man, maybe we should be chasing some of this other stuff because this property was selling for closer to a six cap rate where a lot of the value-add properties we were trying to buy were low five cap rate or even high fours and some of the nicer markets that we were competing in.”

So if you can get that kind of the spread while also buying something new, there may not be the same upside. But you're also not having to buy it and do all that work and capture that upside, which the truth is it may be in the underwriting. You may think you can do it, but you haven't done it. So some of the opportunities we’re starting to see is just is paying attention to the market, looking at – Even if you don't think a deal is going to work for you, look at it, underwrite it, see where the returns are. Ultimately, we’re all chasing yield and we’re all chasing the higher IRRs and higher cash flow.

Sometimes, you get so focused on one particular area. Like opportunistic value-add apartments right now, everybody has money raised for that. That's why we’re starting to change our strategy a little bit to see if we can identify some of the alpha in the markets, some of the opportunity that other people aren’t seeing. Again, we communicate that through our fund vehicle or when we’re calling investors to raise capital for a particular deal, because they always ask the question, “Why this deal. Why now?”

So that's a focus of ours is to have a market strategy and be able to say, “Hey, we’re going to start chasing this deal, and here's why.” That informs the other parts of our process, both with lenders and also with the investors. I see a lot of people chasing a very particular type of deal. Sometimes, as I said, you get very focused on that and you miss some of the better opportunities out there.

[00:13:21] WS: Could you elaborate or give us any more examples of like that better deal where the value that you all are finding or looking for now?

[00:13:28] SO: Yeah. I think one of the things that we are really interested in is the idea that there's been so much opportunistic or value-add investing right now that eventually you're going to get to a point where you're going to find apartments that they've already been upgraded. Or instead of saying, “Hey, we finished the leasing office and we cleaned up the pool and we put a new roof on it and we did 15 upgrades and we’re getting this kind of a increase on rent for that upgrade and now you have 90% of the property that you can go do it.”

Eventually, that’s going to change to, “Hey, we've done 70% of the upgrades and there are only a few left. Who wants this?” Right now, there's not a lot of money out there for I'm done. I've done all the upgrades and so that's what we’re starting to think about too is eventually all of this product, all these people who are upgrading these properties are going to need someone to sell it to on the backend. But all the money is raised to do all the work.

So we’re always thinking about gaps like that. So I think that's the perfect example, and I don't think we've seen it yet. But that's part of why I said we’re trying to get the money raise now and have the dry powder so that we can take advantage of what we see coming. As we all know, we could be wrong. It could be something else or a whole another opportunity. But I think having that strategy gives you something to talk your investors about.

[00:14:40] WS: Yeah. Now, it shows you all are being proactive and prepared. So how are you finding your data? What data are you looking at and how are you finding that?

[00:14:47] SO: A lot of the data we have is through CoStar, which is a service that we use. It's got great data. There are other products out there like Reese that you can get. One of the best actual sources of data now is since we've been acquiring properties since 2012 for seven or eight years now, we've got this database of old OMs. So we’re also using our own existing database that we didn't even realize we were building, because you get a CA on property, you fill out, and they send you an OM. You decide you don’t like it, but you save it in your file.

Then seven years later, you got a property down the street and you’ve got old data that you can go look at and say, “Wow! This is where the market has gone and this is what’s happened with these properties.”

Or collection data is another perfect example. We can go through our files, because it's very hard to find delinquency data. This actually happened to us this week where we went through a bunch of old files from deals that we were looking to acquire and started doing analysis on. One of the actual numbers say for delinquency in this particular area, that particular area. A lot of times, we don't have enough data. But in this instance, we have four or five properties that we were able to find, because we were focused on a particular area and we are able to compare the delinquency in one of our properties today to what the others in the market had.

So that's become a great source too, and that's data that is available to anybody that's willing to fill out a confidentiality agreement with the broker. If you're just focused on particular areas, you can get an enormous amount of data. Obviously, because of its confidentiality, you can’t share it. But you can use it for your own internal purposes and making determinations of that market.

[00:16:17] WS: I love that. Now, that's awesome. Collect all that data. I mean, they’re sending it to you. That’s incredible too. If you have a good I guess filing system or system of saving old operating memorandums and there's so much information there. Can I ask what markets you all are looking in and buying in?

[00:16:32] SO: Sure. Yeah. We’re very focused on the southeastern United States. We are based in Atlanta, and it would just so happened that we love Atlanta. I think Atlanta is a great market. But we like the Sunbelt. We very much believe in the southeast. Our opinion is that the Internet and a number of other factors have contributed to people being able to choose where they live and work. As long as you’ve got some of the basic structure in place, people are going to be able to determine that they don't want snowdrifts. So we see people moving out west into the southeast. Because the southeast is our neck of the woods, it’s where we’re focused on.

So from a market to market standpoint, we really like Atlanta, Charlotte, Raleigh, Durham, the Piedmont Triad in North Carolina, few markets in South Carolina, Chattanooga, Nashville, Birmingham, Alabama, all the way down to the coastal Charleston, South Carolina, Savannah, Georgia, and even Tampa, Florida. We like the Panhandle in Orlando. This time of year, it’s not. We don't like Florida quite as much, because you're dodging hurricanes. But if it's a great state and I believe the data shows where people are moving to Florida than anywhere within the US.

So we think that trend is going to continue. So we’re very focused on small and medium-sized markets today, because we think pricing ends in larger markets have gotten extremely high. But we’re keeping a close eye on all the major markets and cities in the southeast.

[00:17:52] WS: After this hurricane, we may see that switch, right? People going back north?

[00:17:57] SO: Yeah. We dodged it, and we dodged the bullet on that one. It seem to just kind of bounce off. But most of the time, we're not that lucky. So we definitely get that. That's one of the great things about Atlanta in general too. We really don't get hurricanes. Yeah, we get tornadoes. But other than that, that's strange when a few years ago that went right through downtown. They tended not to do that much damage. We have no seismic activity. So between that and our huge airport, Atlanta is definitely our favorite market.

[00:18:19] WS: Do you have an example of maybe a market that you all are really focused on but now have said, "Oh, wait a minute. Because this is happening in the market or whatever it may be in this specific market, we're going to hold off there for a while."? Could you elaborate a little bit on that?

[00:18:33] SO: Sure. I think Nashville is the perfect example of that. I love Nashville. I think it's a great place, and I would love to invest there. But I think the prices are really high. They have done a tremendous amount of new class A development at this cycle. As we approach the end of the cycle, I've got a bad – I remember what Atlanta did, and I think Atlanta has taken a big step forward. But as you approach the end of the cycle and you have that much new construction and your economy is heavily focused on tourism, which Nashville is, I do think that Nashville is something that scares me today. But it's really just a pricing issue. If the prices were a little bit lesser or there was less attention on that market, I would love to be up in Nashville.

That's how we feel about every market. It's really for a price, we're willing to go almost anywhere. It almost always is about how many other people love that market. So when you start hearing I love that market too much, the prices tend to go up. So we have avoided some of the Nashville deals, just because the pricing has been so high.

[00:19:33] WS: I've got to pivot, and we're going to go to a few last questions before we run out of time. But a broker asked you like you're buying criteria. What's your answer?

[00:19:42] SO: Right now, I think we're looking for '80s to early 2000's product, but we're starting to expand that to some newer construction. I do think that our biggest criteria is that if it's something that doesn't have a great box right now, if you're not quite sure who the person is that's going to buy this asset because of one reason or another, we really want that phone call. That's part of our goal right now is we're raising money and our fund to search and seek the properties that aren't getting as much attention to figure out why and if there's an opportunity there.

If you bring in 1985 to 1995 product to market that's all original interiors, you're going to be competing against everybody. It's almost impossible to win that deal for us without paying a really high price. So we're trying to focus on where other people aren't going right now, and I think that that gives us a wide area of age but also gives us some broker something to think about. Whenever they see a deal and they think, "Geez, I'm not sure who's going to buy this. I can call Steve." So that's where really what we're thinking about right now.

[00:20:46] WS: What's been the hardest part of this syndication journey for you, whether from its way back or maybe just a couple – One thing that was like, "This was the hardest part for me to get past."?

[00:20:55] SO: I think the hardest part is the first deal, the very first time that you have to go out and convince people without a track record. The advantage we have now is we can go to people and put in front of them, "We made this much money and this much money and this much money." You still have to make the effort, you still have to raise the capital, you still have to go to the meetings, and you still have to do your job. But the first time, you're basically going out there and saying, "Trust me. I know what I'm doing. I just don't have the data to show you."

So I think the most difficult part was the first deal. I remember all of them when you're going out and you're saying trust me and not just to the investors but to the lender. I remember the first time we got a Fannie Mae loan. The underwriters are looking at you saying, "On whose expertise am I making this loan?" You have to say, "On mine." Then the next question is, "How many units have you purchased?" You say, "Well, none. But let me tell you why. I've got this background and that background, and that's really where my background as an analyst helped."

After spending almost a decade as an analyst at a company like CBRE, I had a lot of credibility. So that really help, but that was definitely the hardest part.

[00:21:54] WS: What's a way that you all have recently improved your business that we can apply to ours?

[00:21:58] SO: I definitely think that focusing on the little things. It’s shocking. But if you get very focused on the major problems that you have, you missed that almost all of the major problems are caused by little problems. So you brought up the model. We’re constantly tweaking our model. We call it a living document. So whenever we see something that we don't like in our Excel model, we change and we make it better. Sometimes, that little tweak can change your IRR, change your cash flow, and you’ve been doing it wrong for seven or eight years.

So we’re focused on that and then also on the property level as well, making some minor changes that will have a big effect on the outcome. For instance, recently this year, we’re making an attempt to go all cashless payments and all checklist payments. So we’re trying to get all of our residents paying through ACH or credit card or some through electronic means. It’s a huge undertaking, but we believe it will help in delinquency and others in other ways. It’s something that you never would've thought about if you’re not really focused on your little problems like how can I prove my delinquency or how can I make it easier for people to pay me.

[00:22:59] WS: It's interesting too, and you all can do that because you're managing your properties as well, right?

[00:23:03] SO: Correct. Yeah. I think one of our big advantages that we can tell people, investors too, that they really like to hear is when you write us a check or when you invest with us, I never lose sight of your money. It never leaves me. Also, we are hiring all the employees. We’re taking care of everything on site. There are a lot of great property managers out there, and we do some third-party management as well. But I do think it is one of our advantages to being able to say, “Soup to nuts, we can do it all for you.” Conversely, the challenges, you have to answer the question of who are you. Are you an investor-operator or are you a property manager? So I think it's a double-edged sword, but we find that it’s beneficial to say that we are in control from day one with every aspect of the deal.

[00:23:45] WS: In 10 seconds or less, what's your best advice for taking care of investors, so they want to come back?

[00:23:50] SO: Do what you say you're going to do. Very simple.

[00:23:52] WS: Number one thing that's contributed to your success.

[00:23:54] SO: Hard work.

[00:23:56] WS: Love it. Plain and simple. How do you like to give back?

[00:24:00] SO: We really like to do it through our family, through our employees. We have over or approaching a hundred employees right now, and we like to make sure that it's a great place to work and that we can take care of people. It actually goes back to what I said about do what you say you're going to do. It's just do the right thing. Treat people well. It tends to be that things turn out well for you.

[00:24:20] WS: Steve, amazing interview. I've really enjoyed it myself and learned a lot. I know the listeners have as well. I know it was going to be very popular. Thank you very much for your time and sharing your expertise. Tell the listeners how they can get in touch with you and learn more about you as well.

[00:24:35] SO: Sure. Absolutely. Again, Steve O'Brien with Arcan Capital. You can go to arcancapital.com. That's A-R-C-A-N C-A-P-I-T-A-L.com, and you have all the contact information for us there.

[00:24:46] WS: Thanks so much, Steve. Great show.

[00:24:49] SO: Thank you. I appreciate it.

[END OF INTERVIEW]

[00:24:51] WS: Don't go yet. Thank you for listening to today's episode. I would love it if you would go to iTunes right now and leave a rating and written review. I want to hear your feedback. It makes a big difference in getting the podcast out there. You can also go to the Real Estate Syndication Show on Facebook, so you can connect with me and we can also receive feedback and your questions there that you want me to answer on the show. Subscribe too, so you can get the latest episodes. Lastly, I want to keep you updated. So head over to lifebridgecapital.com and sign up for the newsletter. If you're interested in partnering with me, sign up on the contact us page, so you can talk to me directly. Have a blessed day, and I will talk to you tomorrow.

[OUTRO]

[00:25:31] ANNOUNCER: Thank you for listening to The Real Estate Syndication Show, brought to you by Life Bridge Capital. Life Bridge Capital works with investors nationwide to invest in real estate while also donating 50% of its profits to assist parents who are committing to adoption. Life Bridge Capital, making a difference one investor and one child at a time. Connect online at www.LifeBridgeCapital.com for free material and videos to further your success.

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