EPISODE 386

[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 Steve O'Brien. Thanks for being on the show again, Steve.

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

[00:00:33] WS: With Steve's experience, I'm honored to have him on the show again. You would have already heard him on the show WS 366. I encourage you to go back and listen to that great episode. Today, a little more about Steve. He's a co-founder and chief investment officer at Arcan Capital. Mr. O'Brien was responsible for the identification, acquisition, management, and reporting of over 25 multifamily assets, totaling over 300 million in value, and he's also secured the placement of nearly 200 million in financing.

So, Steve, thank you again for your time, and I'm looking forward to this conversation today because just your experience in the market and this many deals in this industry. Just the economic outlook and what you see and how this is affecting you all's business is a big topic. Everybody wants to know. Everybody wants to know what's going to happen. So I look forward to hearing your opinion from your experience and how in-depth you are into this industry. But maybe give us a little update about what you all are doing right now, what's happening, and then let's dive in.

[00:01:34] SO: Yeah. I think that's pertinent to our topic today of the economy. I think – Just about everything we do is driven by economic conditions. Obviously, if times are good and rents are going up, it's a great time to be buying real estate. If times are not so good, you could actually argue that's an even better time to be buying stuff. Less competition and potentially better deals. So we're always paying very close attention to the market, and that's what we're doing right now. I think as of today, we're probably net sellers, meaning that we're more likely to sell something than we are to be buying something. I think that's more of a function of just being able to find a high quality product that we believe is going to generate the returns that we want and when you compare that to what we have and what we're being offered.

Someone very smart told me one time that if you're not selling at a particular price, then you're buying it, whether you own it or not. So when somebody offers you X and you don't take it, you're basically saying, "I think it's worth more than X." So we're very careful to make sure that we're moving those directions correctly, and I think now just whether it's strategy or not, we have become more of a seller than we are a buyer. Although I do think fundamentals are really strong.

So we right now are focusing on, which I think is also pertinent to your listeners is we're focused on raising money right now, because we do think that if times are hot and very competitive, that means you're probably right around the corner from a great buying opportunity. So whether it's actively deploying capital or actively raising capital, we're always trying to stay busy and be ahead of what's coming next.

[00:03:06] WS: So being busy, staying ahead of what is coming next. Can you elaborate on just what you see happening and what's it telling you that's happening next? Then let's talk about how you all are positioning yourself even in greater detail than – you're selling as opposed to buying and you're capital raising. What's telling you to do these things? I mean, obviously, there's obvious things that we've all talked about, but what about you all specifically?

[00:03:29] SO: Yeah. I think we do try and pay attention to the macro trends. So I think like everyone, we're looking at trade wars and corporate debt bubbles and all of these other things. But realistically, we're an operator and we're real estate investor. We're not – I'm not an economist. We do not have an economist at our company. So, we're paying attention to those

things, but I think we're really focused on what we're seeing on a day-to-day basis.

That starts I think with what we see in the office, and it translates all the way down, because we are a property manager as well. So we not only see offers and trying to raise money and trying to acquire properties. But we also see residents in the multifamily space coming to us, and we'll notice whether it's easier or harder for them to pay their rent or whether rents are increasing at our properties versus what we're hearing globally.

So I say what we're seeing big picture, starting with kind of macro. I think we're on board with just about everyone else that we're a little worried about trade. I think big picture we're just a little worried, because we're in the longest economic expansion in history. So at some level, you kind of start to think in the back your mind, "All right. How long can this train keep moving in this great direction?" But comparing that with what we're seeing in the market, fundamentals are great. Rents are still going up probably not as quickly as they used to be going up, but they're still going up I think in most places in a very healthy fashion.

And Atlanta is where we're based, and we've got a lot of rent growth here in Atlanta, even with a lot of delivery of new apartments. So we feel pretty good about the statistics, but I do think we are starting to ask that question that I mentioned before of how long can this continue. We're starting to think about getting prepared for if rents don't go up as quickly as they have in the past and what type of asset does that mean you should be buying now versus what you were buying before? How should you be financing it versus how you're financing it before?

Of course, communicating with our investors because if – At least it's our belief that if we see something coming and we can prepare our investors better for what's next, it's just going to make us look better in the long run and make it easier for us to raise money and make us look like a more astute investor.

[00:05:30] WS: I like that. You're just talking about how long can this continue. Clarify me if I'm wrong. You all self-manage? Or you all have your own management company.

[00:05:37] SO: We do. So we soup to nuts. So from our standpoint –

[00:05:40] WS: That's what I thought.

[00:05:41] SO: We like to say when someone invests with us, we follow the money all way down to the property. So we are paying invoices at a property level from our corporate office, and we're also raising that money. So the money never leaves our sight, and I think that kind of helps us see a little bit more of the picture as well from an economic standpoint. If rents go down or if rents start going up really quickly, we're going to feel it because we see that on a daily basis at our assets and through our property management software.

[00:06:07] WS: You mentioned that you'll be able to see or you start to notice if it's easier or harder for tenants to pay rents. What have you noticed there?

[00:06:15] SO: I think it's definitely getting harder, and I think it doesn't take a lot of insight to see that. I mean, you can just go look at the numbers. Our rents are up so much that particularly in a place like Atlanta in the southeast where we're active is a lot of markets that you would call very affordable are changing from very affordable to just affordable. I think Atlanta is the perfect example of that. I do not believe last cycle that Atlanta had any apartments that rented for over two dollars a square foot. Now, they're everywhere renting two dollars a square foot. Almost every new product being delivered rents for more than two dollars a square foot, and that's a very important hurdle mentally for our city, was getting to the two dollars square foot rent. Now, we've blown by that.

So I think you are starting to see some of those signs of people just saying, "I'm running out of money here." I think because of what we do, we're value-add investors, so we do a lot of improvements, whether it's kitchen renovations or property renovations. Our goal is to take something that's a little bit older and fix it up and get a higher rent. I think we are starting to see a lower volume of people. We call it velocity. So we're starting to see the velocity of people who want to upgrade slow down a little bit. You can still lease, and there's still plenty of people who want the higher, nicer unit. But I think there is also a large group of people now who are starting to say, "Oh! I'll take the classic. I'd rather save that money."

That doesn't mean, again – it's kind of like what we're seeing in rent growth. I mean, I think Atlanta rent growth was well above 5% again last year. I don't think it will be well above 5% in

‘19 or at lease going forward from ’19. But that doesn’t mean that 3% is not a great rent growth. I mean, most of the time, you never underwrite much more than 3% your rent growth in my experience. So we maybe just transitioning from extraordinary growth to more normal growth, which in itself could create some unique opportunities.

That’s what I think we’re focusing on, is how does that change even if we’re just going from an uber healthy market to a reasonably healthy market. Does that change your investment strategy? Does that change the things you can do? I think it does. I think there's some things that will definitely change and even be shaken up by even that change.

[00:08:22] WS: Tell me about how financing is changing due to the market conditions.

[00:08:26] SO: In some ways, you could say market conditions are being too influenced by financing, because rates are low and getting lower. That’s part of just living through the last one. Part of your fear is you don't want the lenders to be creating a bubble, but rates are very compelling right now with high 3%, low 4% rates are still out there. So if you're buying apartments at a five and a half cap rate with 4% debt, that's still a pretty good spread. I mean, that's some nice positive leverage.

Now, those yields aren’t lighting the world on fire, but you can still make some positive leverage. I think what we’re getting more worried about is bridge loans for preferred equity and mezzanine loans. I don't think it's anywhere near as bad as it was the last time around in the early 2000s, 2005, ’06, ’07 where things were really getting out of control and overly leveraged. But if you get caught with 90% leverage in a flat economy where it’s coming backwards a little bit, I think you could be in some trouble. So I think we're trying to focus a little bit more going forward on lower leverage, just out of security. Staying in that 60 to 70% leverage area and being able to cover your debt easily and be able to make it through to the other side.

It's very, very tempting all the time to take as much money from the lenders as they’ll give you because of your IRR. The more money they give you, the more your IRR goes up. But that's not always true with cash flow. So we also try and balance – how much of my return am I getting from cash flow and how much of my return am I getting from my sale, because cash flow is easier to predict. In general, you're probably going to be closer if you’re trying to guess or

estimate or underwrite how much cash flow you're going to get in year one. You're probably going to be closer on that number than you are in what you're going to sell the property for.

That's a tough guess. Whether you're looking 2 years out or 10 years out, it's really hard to know where cap rates are going to be and where the market is going to be when you try and sell it, which is why everybody tries to be conservative on their exit when they're doing their underwriting. But I think we're being very aware of lenders and where their rates are going and also the leverage points. So we're trying to stay focused on conservative leverage right now. Actually, the more conservative you are with your leverage and loan-to-value, oftentimes you get a better rate. So it works for you. It just means you got to put more money into the deal and oftentimes be willing to accept a lower return.

[00:10:45] WS: You mentioned you're more worried about bridge loans and mezzanine loans. Would you just briefly elaborate on what those two types of loans are for the listener that's never heard of that before? Then we'll keep going.

[00:10:55] SO: Sure. Yes. So especially in our market with value-add, if we're doing a lot of repairs to property, there's a large portion of the multifamily industry that's the Fannie and Freddie and the agency loans. They really don't have a great product for a property where you're trying to invest a lot of money in it. Whether that's 15 a door or 25 a door, most of the Freddie, Fannie, HUD loans are ideally designed for 90% occupied property with a pretty stable loan amount.

So if you've got a big project on your hands, you can go to a bridge lender who will not only give you that money, they will also fund your improvements as you go. It's a great way to reduce your IRR, and it's a great way to make sure that you don't end up taking out a 70% loan. By the time you've done all your improvements, it's a 50% loan, and that's a ton of equity. So it's very beneficial, but they tend to be more expensive. Their rates tend to float versus being fixed, which is a risk. They will let you go higher up on the capital stack.

So, I mean, I believe and I'm sure you can get higher. But there are plenty of bridge lenders out there that will get you 85% of cost. The idea behind that is, "Once I've done all this work, 85% of cost will probably be more like 65, 70% of the value of the property." But if it doesn't work and

you don't get exactly what you want, you could be stuck with an 85 to 90% loan with debt service that drowns your deal, because the interest rates are almost always higher for bridge debt and floating than they are for the agency loans.

Then mezzanine would be just as an extra piece on top. There are plenty of lenders out there who, in fact, some of them as they – They're equity investors who can't find deals, so they decide to kind of change strategy a little bit and invest, and take your loan from a 70 to an 80% loan. They'll charge you more for it. So maybe you go to Fannie or Freddie for the first 70%, and then you get the next 15% from a mezzanine lender that charges you 10.

Now, if you bundle all that together, your average rate is still going to be pretty compelling, but you're still also paying 10% or whatever for that financing from 70 to 85%. Again, that's just more debt service to pay. If you got more debt service to pay and rents go down, you could find yourself – That's where people end up giving properties back when they can't afford to pay their debt service. So you see a lot of that particularly in the last recession. You saw a lot of people where the property value went down and their loans were still obviously required to be paid, they were unable to pay their loans and ended up losing the property back to the lenders. So that's – I think as you get to the end of the cycle, that's really what we're trying to avoid is to make sure that you can handle some bad weather if it comes your way.

[00:13:27] WS: You never want to be forced to sell. That's for sure. Or to give the property up. So one piece about what you talked about on bridge debt there, the floating interest rate. I've heard some discussions about that recently where it's like – I'd love to have your opinion about this, but where 1% of the time it's actually going up, where that means it's like a really – such a small piece where some people are moving more towards bridge debt, because more times than not it's going down. But what's your take on using bridge debt and right now?

[00:13:54] SO: It's almost like anything else. If you use it well and you do it the right way, it's fantastic. I mean, we've used it before, and I don't know that it doubled your return. But it can really help you expand your return, because on a big project the other lenders just can't compete. It's worth paying the extra interest, and it's worth getting the extra money so that you can increase your return. Everybody would much rather turn a million into two million than turn a million into a million five. That's what the bridge loans really help you do. So I think just like

anything else, they're perfect if you use them the right way.

Now, if you use a bridge loan on a property where the strategy didn't make sense and you can't get the rents, that's why they call it leverage. If you use it the right way, it'll expand your return. If you use it the wrong way, it'll expand your loss. So I think that's where you got to be careful and especially when macro forces – I mean, realistically, if you were buying apartments in 2013, '14, and '15, you are probably going to make money because of what happened, whether you did a good job or not. I think that's where the real test comes is when you're buying at the top or when you're buying near the top where we think we are today, you got to be really strict in your underwriting and really strict in your loans and make sure that you can afford to take a hit in one direction or another. Or that bridge financing can really hurt you.

But there's no question. It's more flexible, and it can really help you expand your returns, especially for some of your listeners that maybe they're looking at a deal and they can only raise $2 million and they're may need three or two and a half. A bridge loan could help you bridge the gap between making sure you're able to get that deal, and that's valuable, and that's a big deal. But you do it at the wrong time, just like anything else, it could be a problem. So that's what you really want to be aware of.

I think as far as interest rates going up and down, that's just so hard to predict. I mean, I don't think there's a person in real estate who thought we'd be at the rates we are today. Everyone has been saying for six, seven years, rates are going up, rates are going up rates are going up. Well, they went up a little bit, and now they're all the way back down near historic lows. So I think playing the prediction game is really tough, and you just got to judge your risk.

It's like having insurance. I mean, you could buy an insurance policy for almost anything. You've got to decide whether you're willing to take that risk or not. I think bridge loans are often really worth it, and other times they're not. Unfortunately, you're probably not going to know whether you made the right decision until you're in the deal.

[00:16:14] WS: So you mentioned preparing to weather that storm. You have to be prepared to weather that storm. I'd love to know how you all are preparing to weather this storm. Or let's say you are looking at deals to buy. How are you preparing with the economic outlook like we're

talking about? What are you doing different maybe than you did a few years ago to weather this potential storm?

[00:16:33] SO: Yes. I think it's multiple different things that we're doing slightly differently. I think as I mentioned earlier, we've become net sellers. We've listened to the market, and when I say listen, we're still out there trying to find properties to buy. We still have investors that are interested, but the returns that we're able to achieve are not as interesting to our investors as they were previously. So what that's done is as it's made it harder to find deals that we want, it's made the exit of deals we already have more attractive to our investors. So it's a double-edged sword. It's harder to find stuff to buy, but the things that you sell you're getting more for, and you're more successful in the stuff that you bought previously.

So I think that's step number one is just sort of listening to the market talk. If we're hitting our numbers and we feel good about a price, we're selling, and we're remaining very diligent in our underwriting and our acquisitions to make sure that we're not just pushing just to buy, I think that's where you get into trouble. So I think that's step number one is listening to the market and adhering to your underwriting standards and not all of a sudden changing, as I mentioned before. Well, we're going to use 6% rent growth to make this deal work. We're trying to underwrite the deal and look at the deal. If our investors look at it and the IRR is not appealing to them, then we're passing as we had, and we're just passing on almost everything now.

That's the reality of what's happening. We're having a very difficult time hitting the yields and getting to the required returns that we think are necessary to invest in properties. So we've adjusted that way. I also think in order to make sure that we're prepared, we're looking forward and we're putting – We actually put a fund together, because we're using it as an opportunity to raise money. Whenever anything changes, we try to use that as an opportunity to raise money to get our message out there, to talk about what we're doing.

Obviously, if we're not acquiring anything, there's a lot of effort and work that goes into acquisitions that you now have time to focus on other things. Our belief is that we communicate with our investors and tell them, "Hey! This is what's going on in the market, and here's what we expect would be next." Not only is it a good opportunity to raise money, but it's good opportunity to talk to new people and share your expertise and experience with them. You never know

where just that conversation, even if you're not raising money, you've created new contact, and they could be someone that invests with you in the future when you do have a great deal.

So that's what we're doing is what we're trying to create some dry powder for what we believe the next 24 months will be, which is, as I mentioned – when things go really well, it's good, and when things go really bad, it can be good too. It could be an opportunity to acquire assets. Most of the time, if there are some struggles in the market, there will be people who exit. People who just get out and say, "I don't want to deal with this." That can be a great buying opportunity in particular markets in particular areas.

So I think those are the two things that we're really doing. Also, on top of that because we are a manager too, we're focusing on operations. Really making sure that everything is running as smoothly as it possibly can and starting to look at some of those loans, starting look at some of those properties. If we feel there is any exposure, is it something that we want to sell? Is it something that we want to refinance the loan? But basically, just be prepared. If you have a bad feeling that something may happen, do whatever we can do to try and use it as an opportunity or insure against the problem by preparing for it.

[00:19:36] WS: What about the types of deals or the markets that you all – I know you're in Atlanta, but are you still looking in the same markets or have you said, "Okay. This market is – This is happening here. We're getting closer to this economic bubble. Maybe we're going to look somewhere else."? Are you doing that or is it kind of just over all, "We're kind of slowing the buying process down and focusing more on operations and possibly selling some?"

[00:20:00] SO: Yeah. I think we're still – We are definitely doing that, and I think we're doing that with markets but I also think with asset types as well. So, from a market perspective, we've always been very fluid. We like the southeast, and we like particular markets in the Southeast. But at some point, if you give me a good enough deal on something, I'll go almost anywhere. I think what we're really looking for, we say we're looking for alpha. So we're looking for an unexplained return. We're looking for things that don't make sense in the market inefficiencies.

So sometimes, we found that those inefficiencies are – We'll go to smaller markets in Georgia, a place like Macon or Savannah. If we see the pricing in those smaller markets is getting similar

from a cap rate perspective or a price per unit perspective to Atlanta, our opinion is why wouldn't I be buying in Atlanta. So sometimes, we focus on Atlanta when we feel like pricing become very similar across secondary or tertiary markets and classes.

Then we'll do the same. Sometimes, when Atlanta feels very expensive or Raleigh-Durham feels very expensive or Charlotte feels very expensive, we'll focus on the secondary, tertiary markets around there to try and get a discount. Let's say something in Charlotte are selling at a five and a half cap and we can find a very similar property for six cap in a suburban area of Charlotte, we may go with that and feel like we're adequately compensated for picking something in suburban Charlotte versus downtown Charlotte.

So I think we're always looking around for different markets to see is there any mis-pricing anywhere. Do we think – Are people really afraid of a particular market when we don't think they should be? Or are people really high on a market when they're – It's a great market, but it's not worth paying that much when you can get a little bit of a discount to go somewhere else.

So I think that's what we're doing from a market perspective, and I think what we're seeing that's a little bothersome is that cap rates everywhere are starting to go down and be similar and also across product types. The gap between class C and class A, aside from I think the ultra-high-end AAA brand new construction, cap rates are really tight everywhere. The spread between a high-quality deal and a very low-quality deal in a cap rate perspective is not enough for us. So we're staying away from the very, very low-quality deals right now, and that's just because we think that you should get a big premium for buying older deals that are in a questionable neighborhood that need a lot of work. We think those should trade at a lower number.

So as we see all that kind of come together and yields tighten up, we're going to focus more on quality, believing that you're not getting enough of a discount for lower quality. So I think we're going to focus on a slightly higher quality asset and a slightly higher quality neighborhood. Still, we're willing to zig and zag a little bit to make sure that if the cap rates are high enough in a suburban area or a neighborhood, we'll go there as long as the returns make sense.

[00:22:43] WS: So how are you handling the investor questions now when you are presenting maybe a lower return and they're like, "Well, wait a minute, Steve. There's other operators." Or

they think there are anyway because maybe in the past there's been other operators that are offering the higher returns, or the ones we've seen over the last so many years. What does that look like? How are you handling those objections or just concerns?

[00:23:05] SO: Well, I think sometimes it's as simple as – I'll give you a good Southern saying here. Sometimes, it's as simple as just saying pigs get fat, hogs get slaughtered and just reminding our people that taking a good return is better than none. Or taking a good return is better than losing money. So I think a lot of it depends on the money and what they want to get out the door.

People, and we are too, have become spoiled. I mean, returns have been very good. So I think everyone wants to hit big IRRs, but that puts you in a situation where if you're only going to do those, what do you do when returns come back down to earth. If you review historical statistics, real capital analytics, the returns of the last eight years are an anomaly. They're normally not as high across the real estate investment spectrum.

So I think everyone should be prepared for it, and we've done that through just educating our investors. Talking to them, sitting down, and telling them, reminding them of, "Remember 15 years ago? Remember 10 years ago?" And then asking that specific question is, let's just say that returns are here, "Are you still a buyer? Are you not a buyer?" Because it's not as if I think with my limited knowledge of other asset classes, I can still look at the stock market. I think anybody can tell you it's not like the stock market's cheap.

So if you want to allocate some money to real estate and – it's a matter of alternative investments I think. I don't know anyone who has. If they do, I wish they'd call me. But I don't know anything that's cheaper now across real estates, stocks, anything. I haven't heard that said in a while. So I think you're almost getting into a point where you're reminding people that real estate is a great asset class. You should have exposure to it. If you're buying, you have to make that decision. Are you going to buy nothing and sit on cash or are you going to be smart and allocate some? But I think that's one of those questions that everyone else has to ask. I don't think anyone is saying at this time in the cycle, "Take everything you have and put it here."

So I think it's about getting some exposure and maintaining exposure, because we don't know.

For all we know, this could go on for another 40 years. So you want to make sure you get a little of it in case that happens. But you also want to be prepared in case it doesn't. So we just like to have those conversations with our investors and make sure that they understand what they're giving up. It's very easy to say, "Oh! Well, this deal is not a 20 IRR, so I don't want to do it." At the same time, if you wait another year for that 20 IRR, then you could've taken the 17 and gotten the same thing because of the time value of money, right?

[00:25:31] WS: Right.

[00:25:30] SO: If you're sitting on it for a year and don't do it. So that's we're trying to remind people that – I think it's a reasonable thing to do that we'd just say, "Hey! It's been a great run, and I'm going to sit on cash until everything looks really attractive again." But that means that in the meantime, you're not making any money on that, because I don't know what the risk-free of money market is right now. But I know it's not very attractive. Savings rates. Nothing is very attractive.

So that's what we're really doing is having those conversations with people and talking to our investors and trying to get their opinions on where they want to be and what they want to do.

[00:25:59] WS: Well, unfortunately, we're out of time, Steve. But just a – I know this is going to be a popular show. Everybody's worried about what's going to happen and just kind of want to hear your opinion. So it's great. I appreciate your time. Tell us again how you like to give back.

[00:26:14] SO: We're doing a bunch of different stuff. In fact, we're actually looking at some new charitable organizations that would enable us to provide some housing on vacant units. So we like to use our company if we can to provide some opportunities to give back and stay within our industry.

[00:26:29] WS: Well, thank you again, Steve. Tell the listeners of how they can get in touch with you.

[00:26:34] SO: Yeah. The best place to reach me is our website, which is www.arcancapital.com. That's A-R-C-A-N-C-A-P-I-T-A-L.com.

[END OF INTERVIEW]

[00:26:43] 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]

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