EPISODE 582

[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]

[0:00:24.1] WS: This is your daily Real Estate Syndication show. I'm your host Whitney Sewell. Today, our guest is Dan Handford. Thanks for being on the show again, Dan.

[0:00:32.8] DH: Glad to be here Whitney, as always.

[0:00:34.7] WS: I know if you've been listening to this show very long at all, you've heard Dan and I have numerous conversations. He has become an expert in the syndication business and growing an amazing brand and he shared, been very generous with sharing how he's done that in numerous episodes and I would encourage you to go back and listen to those.

A little about him: he has an extensive successful background and starting multiple seven figure businesses from scratch including a large group of non-surgical orthopedic medical clinics located in South Carolina. He's the founder of the Multifamily Investor Nation, where he educates a nationwide group of over 25,000 members of multifamily investors on how to properly invest in multifamily assets. He's also the cohost, along with his wife Dennae of the Tough Decisions for Entrepreneurs podcast.

Dan, thank you again for your time. I'm looking forward to another discussion and something that's kind of come out new in the industry lately and you all have implemented as well and just the different capital stacks, what that means and you know, how we maybe even talk about that to investors. Looking forward to getting into that discussion. But grateful for your time.

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[0:01:37.8] DH: Yes, thank you so much, Whitney for having me. And before we get started, I just want to mention to your listeners that if you've heard about the Multifamily Investor Nation summit that's coming up, it's actually coming up on June 11th, 12th and 13th. Would love to have you there and we have over 40 speakers. It's all virtual and this isn't. We're not just doing a virtual this time because of COVID-19. This is actually the 4th time us doing a virtual live event like this and have all the speakers were coming in live and still got to interact with them and you can go to mfinsummit.com to find out more information. If you use a promo code that we created for Whitney, W-H-I-T-N-E-Y, just his first name, Whitney, then you'll receive $100 off. And then if you purchase your ticket with his promo code, we're going to give 100% of the proceeds to his non-profit charity as well.

Thank you for having me on, Whitney, looking forward to diving into this and about this is different types of capital stacks. But also, I think one of the best ways for us to start is really kind of discussing what is a capital stack. Because you know, capital stacks have always been there but it's really kind of a different structure of these capital stacks that's really been something that we've started to see over the last probably 12 to 18 months.

[0:02:45.4] WS: That was going to be my first question. Because I know we use terms like that all the time, talking about different things in the syndication business and properties that were working on our deals but if somebody is just listening or even investors that are thinking about the investing with an operator and you're talking about a capital stack or numerous terms that we use. It could turn them off in a big way. Because if they're confused or if they doubt in any way, their answer is usually going to be no, right? What is a capital stack Dan, before we jump in, what does that mean?

DH: Yeah, these terms are sometimes like you said, you know, are confusing for some of the newer investors because they don't know what it is. And I mean, I'll be honest with you, I didn't know what it was in the beginning either, right? I kind of understood a little bit as to what it might have been, but to really understand will help you even when you're trying to invest yourself but also has an active syndicator putting these projects together to have a good grasp on these terminologies important. It's just like even preferred returns, you know? I do weekly webinars to our MFIN group and I did a webinar recently, actually earlier this week and I pulled over probably 200 people that run that webinar and I said, "How many of you new in here I've never even

heard of the word preferred returns. Or you just have no clue what it is?" I probably had at least probably 30% of the people that are on that webinar that had no clue what a preferred return is.

This obviously isn't about preferred returns, we're going to talk about those in another episode with you which will important for some of you who are listening, don't know what those are and why they're so important for you.

But as far as the capital stack is concerned, it's important to understand this because if I tell you that your position on the capital stack is at the bottom, you might think, "Well, I want to be on the top, right? I want to be at the top of the capital stack." But really, the lower you are in the capital stack, especially from an equity stacking standpoint, it's actually better for you, right? The actual capital stack itself and it's not just in multifamily or – it's in all types of commercial real estate or any other types of equity structures, even if you're buying a business. If you're trying to pay somebody for a particular product or if you're trying to pay them for a piece of property, how are you going to get the money to be able to buy that particular asset?

In multifamily, obviously, we're talking about these large assets. Let's break it down really easily for everybody quickly because there's four main components of a capital stack. At the bottom of the capital stack is going to be your senior debt, right? This is going to be your main lender, they're going to give you that 70 to 80% loan to value and then above that on the capital stack is going to be some form of maybe preferred equity or a mezzanine debt position or a secondary loan holder, something like that.

And then, on top of that is going to be your common equity and your common equity might have a couple of different slices to it which we're going to talk about two different types of capital stacks today. We're going to talk about a single tier capital stack in that common equity of piece, and then we're going to talk about a dual tier structure inside that common equity piece and break both of those down so that you can understand them. Because if you understand the nuances of them, it will help you be able to be more confident when you choose which class of investment you want to be in but those are the four main pieces.

Really kind of – I would say, there's four because you can have the senior debt position at the bottom and then on top of that would be your secondary debt, like a mezzanine debt type of po-

sition which you don't see too often in these types of projects for multifamily but that is one of the pieces that could be there. On top of that would be your preferred equity and on top of that would be your common equity.

Now, there's two different things that you have to understand about the capital stack to really have a better understanding of it. As you go up the capital stack, the risk in that investment goes higher and higher. The lower, again, conversely, the lower you are in that capital stack, the lower the risk you have. Now, the returns are also commensurate with that level of risk, which is why when you have a lender who is giving you that debt for three, four, 5%, they're going to lower return because there are overall risk is a lot lower than anybody else in the stack.

Once you started to go above that 70, 80%, that's when that level of risk starts to go up. When you're in a particular project, you need to see where your actual equity would line up and fall in that particular equity stack.

And then the second thing you have to understand is your priority in that capital stack. The bottom of the capital stack is always going to have the highest priority and as you go up the capital stack, that priority goes down, right? Obviously, the senior lender's going to have the highest priority and what we mean by priority is how are you going to get dispersed on cash flows as well as when you sell the asset?

When you sell the asset, obviously the first thing that gets paid is the debt., right? The debt's going to get paid first, they're the lowest in the capital stack and they have the highest priority. And then as you go up, those buckets will be filled up as you actually saw the asset too.

[0:07:33.2] WS: I love how you break it down and just t hose tiers, just walking through the stack like that. I think that helps build that mental picture as well but not only thinking about. I mean, thinking about the risk the returns and who gets paid first, right? Just really laying that out and how it affects each part of that process.

[0:07:50.5] DH: Well, it's important to understand because the more sophisticated you are and I'm not talking about the credited versus non-accredited. I'm talking about really just being so-

phisticated enough to understand this capital stack, you will be able to understand how you can kind of risk mitigate your portfolio, right?

Because, if you're always in a position where you're not maybe in a preferred equity position, maybe you want to look at some of these dual tier structures and be in a preferred equity position and you also have to run models and analysis to see if, "I get a higher preferred return but no participation of the upside, some of these other classes of shares well, what would happen in my return if I get more return now and I can reinvest that return, where will my return end up being when we're going full cycle on a project?"

Understanding where the risks are and where your priorities are will help you understand which one will be the best position for you.

[0:08:42.7] WS: Let's jump into the common equity a little bit because obviously that's going to affect the investors, you know, most people that are listening. While we all need to understand that stack, we need to understand from the bottom of the top, I hope. I hope each investor that's investor that's investing a deal understands that. But what they have to decide ultimately if we're doing different slices like you're talking about if they're single or double or you know, different ways that they're seeing they get the offerings from different operators like us and then, they see something different like the dual split.

You know, it's all of a sudden something new and it's hard to understand, "Well, what does this mean for me and my investment or my returns, what's best for me?" Let's jump into that a little bit.,

[0:09:21.2] DH: yeah, I want to first talk about the single tier just real quick because that's something that people have already seen, they understand that pretty straight forward and I can dive right into that dual one because it's definitely one that has – that does create questions and again, our group tries to have a high touch with our investors. And so, if any of our investors have questions we just try to reach out to them. B

ut one thing that I will say is I've been on stage but also in conferences where other people are on stage where I see the speaker that you know, that's usually pretty well known, they talk about

how investors are kind of have like a lizard brain if you will, right? They're dumb if you will and they don't know how to understand these different types of structures. And I would say, that's a bunch of baloney, if you will, because these investors didn't come in to the money that they have. Usually because they were dumb, right? They're usually pretty smart and they're pretty sophisticated and if you explain it to them and then understandable fashion, they can get this, right? They don't need to just have these little straight forward basic structures given to them.

But you're right Whitney, you have to be able to explain it to them in a fashion that makes sense to them. One of our prior episodes that I did with you, we talked about how to find high net worth investors and how to build a fence around them so that they'll want to invest with you. And one of the things we do is we send out a newsletter to our investors. And in that newsletter recently, we actually did an article on this particular topic to educate our investors before we even do a project like this so they understand the different capital stacks. And so, before we start to influence like this, we want to make sure we educate them.

So, it's a single-tier equity structure. Typically, of course, the bottom of the capital stack, you're going to still have your senior debt position. And then right after the senior debt, you're going to have your common equity class A. When we say single tier, we're talking about single tier for the limited partners, right? Because even though this is a single-tier structure, you're still going to have two levels inside of the common equity.

Because one's going to be for the GP, the operator for their spread on the common equity which would be in this particular scenario, a class B share and then the class A share is going to be just a single-tier, that's the only option you're going to give your investors and usually going to see something like a 70/30 split, you know, 80/20 split, somewhere around in there and you're going to have some form of a preferred return, some people don't do preferred returns but you know, we're not going to have that conversation today either but usually you'll see a preferred return in there, that's it. So that you only really have one option, there's really no decisions other than, "Am I going to invest or am I not going to invest?"

As we talked about earlier, you still have priority and preferential treatment over the class B in this situation which class B is going to be the operator shares, the GP shares, right? The in-

vestor's going to get paid first and then the operator is going to get paid when it comes to getting their initial capital back and preferred returns, before there's any type of equity split.

And then, obviously, same thing with risk. They're going to be in the middle piece of the capital stack so it has you know, moderate risk. And then of course, the GP is actually going to have the highest risk in this particular capital stack. That's the single-tier. It's usually pretty straight forward, easy to understand.

The second one that we're going to talk about today is called the dual-tier equity structure. The dual-tier is going to be similar in makeup to the single tier but you're going to have two slices of the common equity for the investors to choose from. You're going to have class A, and you're going to have class B. Then of course, in this, when you're also going to have class C which is going to be for your operator, your GP shares, right?

Inside of the investors shares though, you're going to have that class A which really acts as a preferred equity piece. So, you could call this preferred equity class A, if you will, for shares and then after that you are going to have class B and then which is going to be typically like your single tier where you are going to have that 70-30 split participation for the upside. And then of course your common equity C, which is going to be your GP or operating shares.

And some of you might be thinking, "He is going through this really quick," and that is one of the nice things about doing podcasts is if somebody is talking really slow, you could actually speed it up, right? But if somebody is talking really fast like I typically tend to do, you can also slow it down and listen to it at one and a half if you want or back rewind and listen to it again. I just get really excited when I talk about multifamily investing. And so, it is hard to slow it down Whitney but those are the different dual-tier and the single-tier.

But the biggest thing with the dual tier is that in class A because it is in a lower position of the capital stack it has higher priority over the other common equity pieces. And so, they call that a preferred equity piece and they don't get as much – they don't get any participation of the upside. So, it is usually about a nine to 10% preferred return, no participation on the upside because the rest of that upside is being given to a class B investor and it lowers the risk for that

preferred equity piece and you are going to get higher yield month over month because you are in the lower position of the capital stack.

[0:14:19.3] WS: What is the upside? You talk about upside just in case somebody doesn't know what you are referring to there, what does that mean?

[0:14:25.2] DH: So, what the upside we are talking about is in class A in that preferred equity piece you are going to have a capped return, right? So, they are going to say your preferred return is either nine or 10% and you're going to get no upside, meaning when we sell the asset or if the cash flow go above that point, you won't get any more than nine or 10%.

And so, what you are doing there is you're – well, if you invest in class B, then you're going to get lower cash flows, right? But you are still going to get a higher return overall when you actually sell the asset, you will get a higher return because you are participating on that upside and the appreciation of that asset when you sell it. But you are giving up on class A that participation in the upside of that sale of that asset to be in the lower position of the capital stack because the way it works and the priority levels is that before anybody else gets paid, the class B's or the class C as the operator, the class A's must get paid their 9% or 10% first, before anybody else.

And so, it's as close to a guarantee as you can give to an investor, even though there is still not a guarantee. But it is as close to a guarantee as you can get especially because this is usually only about 25 to 35% of the capital stack. If it was more like the other way around or is like 60 or 70% of the capital stack on that preferred equity piece is going to be a little bit out of balance and so the lower amount of class A that is available, it lowers your risk as an investor in that particular equity slice because there is only a limited amount of investors that are in that particular piece of the capital stack.

[0:16:00.4] WS: I was going to say there is usually going to be a lot less investors in that but then there's also going to be a higher minimum investment as well, right?

[0:16:06.4] DH: Yeah, typically you will see about a $100,000 as a minimum investment. I have seen you got some will be up to $250,000 and so you definitely are going to have some extra

restrictions there, which is going to be might prevent some people from being able to invest in that one.

[0:16:21.3] WS: So, could you give us an example Dan of maybe an investor, maybe their situation a little bit why you know one tier worked for them as opposed to the other or one class as opposed to the other and just helping that investor think through their situation a little bit and why they might pick one over the other.

[0:16:37.2] DH: Sure, so let us talk about in this dual-tier structure, let's talk about the class B first. So, this is just a common equity, they get participation on the upside, lower preferred return. So instead getting that nine or 10% in class A. They are going to maybe get seven or 8% in this class B. And the person who wants to be embarrassed is going to be somebody who really doesn't need a lot of cash flows right now, they are willing to take lower cash flows to have higher participation on the upside. Or when we actually sell that asset right? And so that is somebody who is maybe still working right now, they're still producing revenue, they don't really need the cash flows.

Now, opposite of that is somebody who is maybe retired, right? Or getting close to retirement and I had an investor calling the other day in one of our projects and he said, "I think I am just going to invest in class A because I don't know if I am going to live to see this deal go full cycle." He's like, "I might only live for the next five or seven years or something like that." And so, he's like I prefer to have the higher cash flows now to be able to use those to live off of instead of waiting for the full cycle of the deal.

And so that's a perfect example as to why somebody might want to be in this position is if you want to live off the cash flows, right? And we had several investors that actually do that. But then you also have the more sophisticated investor that says, "If I can invest in class A and get 10% or 9% right now, I can reinvest those cash flows and still get a higher return but I have lower risk." And so, it just depends on the investor and how comfortable they are in the abilities to be able to reinvest that class A money that they are getting from distributions.

[0:18:07.3] WS: Okay so somebody like you said, that's an interesting thought, they can invest in a class A they get more cash flow now and then they just turn right back around and invest that capital faster so –

[0:18:17.4] DH: Yeah. Danny on our team is actually in the process of putting together a model to actually figure that process out of what would be a typical return that you would get if you reinvested these proceeds every single month. And whether you put it into some sort of like a low risk or moderate, you know mutual fund versus maybe a money market account that gets a lower return. But how are those to returns shake out depending on which investment vehicle you redistribute it into.

[0:18:40.6] WS: Love that and you can also split it between a couple a lot of times, right? You know maybe a $100,000 minimum. But we might do 75 in one and 25 in another, how do you normally see that?

[0:18:50.4] DH: Yeah, so that would actually be what we call our blended option. So, you have a blended return. So if you said 25-75 or 50-50 or however you want to split it up, the minimum is a 100 total investment usually and so they can split that 100 up between class A and class B of however they want or they could put all of it in one or all of it in the other, right? Usually in class B you are going to have a lower minimum. It is usually about $50,000 minimum.

But somebody who is like, "Well, I want a little bit higher cash flows now but I still want a participation in the upside." It is nice to have that diversified portfolio and risk in the same investment by having that blended option of investing in both asset classes.

[0:19:31.1] WS: So, have you seen any other capital stacks that are different than maybe what we have discussed? And we won't have to jump into them but anything else that you have seen operators do that maybe we could at least make people familiar with or at least just start to learn about?

[0:19:42.7] DH: Yes, so there is a lot of different ways to structure these things and I even recently saw one come out where they had a third-party come in and actually bring in the pre-

ferred equity piece and then on top of that they had their own preferred equity piece that is dual tier income and equity and then the GP shares.

And so, there is a lot of different unique ways to how to structure this, the same way that there is different ways to actually kind of lay out the waterfall if you will of how these different returns might change and split over the life of the property and over what you are actually giving out proceeds. When I say waterfall I am talking about if I give right now seven or 8% as a preferred return to the investors, well once we hit the next hurdle on the waterfalls, they call those hurdles, once we get to say maybe 12 or 13% IRR when we sell the asset, the equity splits might change from that original 70-30 split to maybe 50-50.

And I have seen where they have dual hurdles in the waterfalls. I have seen three, four and five different hurdles in the waterfall structures and it does make it a little bit more complex but usually with our group, the way we handle it is we do what's called a performance-based hurdle because again, we are trying to make sure our investors get the returns that we originally projected. So, we project a 15% IRR or a 20% IRR then we want to make sure they can get that. But if we outperform the property it goes above that then that is when we change our splits from 70-30 to 50-50 to incentivize the operations to be able to outperform that property.

[0:21:08.5] WS: Before we run out of time, a couple of questions maybe as a passive investor that they should be asking the operator. I know we talked about some of these in previous episodes but specifically about the way the stack is.

[0:21:20.4] DH: Sure. Well, I think the biggest thing you have to do is not only just asking them but also reviewing the PPM, the private placement memorandum very closely and the operating agreement to understand where your position really is in this capital stack structure. Because obviously you know we are talking about capital stacks where that preferred equity is on the bottom and then you have the common equity on top. But there can also be a difference of that where they are almost like at the same level, right? And then you have this problem with being able to potentially not be able to get some of your investment money back if the deal starts to fall through.

And so, in that preferred equity position one of the things that is important is that priority because if the deal starts to fall through and it is only 25 to 35% of the capital stack, if the deal falls through and there is money to distribute at the end of the deal, guess what? You want to make sure a preferred equity person that you are getting your initial capital back first before anybody else does.

That's why it is lower risk because you are getting that preferred return first and you're cash flows first and then you are also going to get your initial capital back too. And so,– but some operating agreements aren't written that way. They are written where if you sell the asset then the initial capital is given back pro rata of sharing based on your investment amount with class A and class B and I don't want to have that. And so, that's a big question mark that you are going to have when you are looking at investing in these is looking at that distribution schedule on the sale, on cash flows and also any type of capital event like a refinance or supplemental loan.

[0:22:50.8] WS: Nice. Dan, I love the way you explain this and laid out the capital stack so all of us can understand, better understand how that works. It can be very confusing if you are first coming in as a passive investor or even just trying to become an operator thinking about what all that means. So grateful for your time. Tell the listeners how they can get in touch with you, learn more about you and passiveinvesting.com but also the summit that's coming up.

[0:23:13.9] DH: Sure. So, if you want to find out more information about our group and possibly join us on one of our future properties, you can always go to passiveinvesting.com on the top right hand corner of the page there is a little button that says "join the passive investing club" and so, you can join our club. I will have my assistant reach out to you and schedule a phone call one on one with me to discuss your investment goals and see if we're a good fit.

Because if we are not a good fit for everybody and we want to make sure we have investors that want to be with us for the long term. And so, we'd love to be able to have that conversation with you.

And then the second thing is about the summit coming up. You can go to mfinsummit.com and find out more information about the summit. It is coming up on June 11th, 12th and 13th and if you are listening to this after June, you can still obviously go there and find out about the next one

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which is already scheduled in January 2021 and if you go there and you use the promo code "Whitney," W-H-I-T-N-E-Y, you'll get a $100 off your ticket and you'll be able to support Whitney's organization, his non-profit because we are giving 100% of the proceeds from the tickets sales from his promo code to the non-profit.

So, go there now and check it out. I would love to have you there. We plan on having over 1,000 investors at this event. We had over 800 of them in the January one that we did this year and I am looking forward to having everybody there. Thank you so much, Whitney for having me on.

[0:24:25.9] WS: My pleasure, Dan. As always.

[END OF INTERVIEW]

[0:24:27.9] 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.

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[OUTRO]

[0:25:08.9] 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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