EPISODE 608

[INTRODUCTION]

[0:00:00.0] 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]

[0:00:24.4] WS: This is your daily Real Estate Syndication Show. I'm your host Whitney Sewell. Today, our guest is Serge Shukhat. Thanks for being on the show Serge.

[0:00:33.2] SS: Thanks for having me.

[0:00:34.9] WS: I'm grateful that you're a listener of the show as well and I'm grateful for you sharing that with me and listening. But a little about Serge in case you haven't heard of him before. Currently owns over 500 multi-family units in a personal portfolio. Former CPA and corporate controller of a tech company. He's been a full-time real estate investor for over 10 years. Tell you what Serge, your BiggerPockets link — we'll put in the show notes so people can meet you there and connect with you on BiggerPockets, is that right?

[0:01:02.0] SS: Absolutely, yeah.

[0:01:03.0] WS: Awesome. Serge, give the listeners and myself a little more about who you are, maybe where you're located and let's jump in to your specialty, your super power.

[0:01:10.6] SS: Thanks Whitney, long time listener like you said. Love your show. Appreciate you having me on. I am a multi-family real estate investor, based out of Phoenix, Arizona. I live in central Arizona and invest throughout the state in both primary, secondary, and tertiary markets. What makes me a little different is that my wife and I, that is, purchase multi-family assets on our own accounts, meaning that we're not syndicating deals. We're not limited partners, you know, doing that route, a lot of your guests do. I understand that strategy and I've actually done syndications in the past. I appreciate the power of it but for me, I'm trying to build long-term generational wealth and a balance sheet that can be both tax preferred during the buildup and tax preferred during the hand-off to heirs and multi-family uniquely situated to do that, it's been a long road for us from starting with single family, all the way through to multi-family — I think it's another unique thing that's different from a lot of your guests.

We started with a single family and built up a decent sized single family portfolio. Sold those homes into this 2019, 2020, really over the last two years. Sold those and I'm primarily overseeing as an asset manager. I think of my job as an asset manager right now. Asset managing the multi-family here in Arizona.

[0:02:39.0] WS: Wow, I want to get into that a little bit about numerous things that you just mentioned but you know, you're investing in numerous markets or primary secondary markets. I'd love to have your thoughts on that. You're in Arizona, you're investing in numerous markets there but what's your thought process behind primary, secondary markets and why one or both?

[0:02:58.2] SS: You know, every city or market, if you want to separate it between primary and secondary, they have their time and place, right? Primary markets are great to buy at a very specific point in the cycle. As are secondary markets. It depends, I've always been an opportunistic investor where I'm willing to take what the market's going to give me.

I'm not tied to a city, I'm not tied to a state, I'm not tied to an asset class, right? I love multi-family right now and it's been great for me over the last 10 years but right now, as we're looking at a post-COVID world, I'm open, I'm looking at resale. I'm looking at office. Everybody's leading them for dead, everybody's saying how office space is going to change forever and never be the same. Everybody's saying office owners are going to make a rush into multi-family and other asset classes. Retail people are talking about a 40, 50% vacancy rate into 2020 for a lot of strip center retail, a lot of what otherwise would be Class A and Class B retail. I'm open to looking at that, you know? So, right now I'm studying, I'm looking at you know, what kind of income they had pre-recession? How much does it cost to buy that income today, what are the risks in the future, how do you underwrite those risks and so when the right deal comes in 2020 and I get that phone call, I'll be ready to buy a 57,000 square foot office building in downtown Phoenix, right? That everybody else is scared of. Like I said, every asset class has a time and place, right? When everybody's scared of it, when everybody hates it, that's when I'm looking at it.

[0:04:40.9] WS: I love that. I just like having an open mindedness to think through that, when everybody's running away.

[0:04:46.2] SS: Yeah, people forget what's today's discounted and hated asset class is tomorrow's sweetheart, right? The status that multi-family has today, that wasn't the case 10 years ago, right? 10 years ago, multi-family was you know, multi-family and single family. Residential real estate was not where you wanted to be supposedly. But then, in hindsight, looking back five, 10 years, it was where you wanted to be. The world will change post-COVID certainly but I think it changes a lot less than people think.

[0:05:21.1] WS: You know, tell us a little bit about you know, you've been part of syndications before, you had syndicated deals in the past but now, you've changed that a little bit or your plan. How you and your wife are moving forward. Why not syndicate any more?

[0:05:32.6] SS: I am particularly not looking to be beholden to investors. I'm not looking for quarterly reports. I'm not looking to build those systems. I'm not looking to have a partner, two partners and having to do five, 10, 15 deals a year. I don't want to do that. I want to do only the best deals, only the best assets and because of where we are at currently, we don't need to do a deal. If we don't do a deal in 2020, that's fine. We don't do a deal in 2021, that's fine, we can sit and wait, you know, and build relationships and be best friends with the brokers and when they know what you want and when it comes, they call you and you buy it.

You know? You're prepared. But having to constantly be on the lookout. I think it really — and I've seen it happen to other investors who I know. Investors that were very sound underwriters, looked at assets the same way I did and the minute they got into the syndication space, now all of a sudden, it was okay to underwrite 7% economic occupancy instead of the 12 to 14 that they know it should be. Now all of a sudden, it's okay to comp to an asset that is five miles away in a completely different neighborhood that you shouldn't be comping to that you know, you can't comp to that. Now, it's okay.

You find yourself, because of that fee, you find yourself taking a more bullish approach than you necessarily would I think. I've seen it happen to people and it takes a very disciplined person and investor and sponsor to not do that and they're out there and I know them by name that are not. Just the passive investor, you're kind of rolling the dice. Which one of those two buckets do you have? You have the guy that needs that fee to pay his mortgage or do you have the guy that's building long-term 20-year relationships on solid foundational assets.

The purchases that I saw being made at least in my state, let's call it Maricopa County, Phoenix in 2019 and '18 were not those assets and are not those assets.

[0:07:40.8] WS: Yeah, wow. No, I think it can change your mindset sometimes on investing once you have seen it happen in numerous people when you're in the position where you don't have to do a deal in 2020 or you know, you reach that level of financial security and I think now you can really raise your standards — which we should all have high standards on what we're buying, no doubt about it. And like you were talking about, I've seen it too. It's unfortunate, they are forced to buy deals, they feel like they're forced to buy deals because they need the income and that's not a place we want to be in.

You had mentioned also like everything or maybe you and I were talking before we started recording — you said that you're investing in right now is for your own balance sheet. Elaborate a little bit on maybe your deal criteria and how it's helping your balance sheet even in this pandemic and how that's changed things?

[0:08:26.5] SS: You know, my deal criteria is quite unique and you know, when I'm first introducing myself to you know, a broker, an out-of-state broker, I kind of keep it to myself. I'll keep the criteria as far as you know. "I like this class, you know, B-class building and this kind of location and this many units," that kind of stuff.

But the cash-on-cash that I'm looking for is probably still outrageous sounding, that these brokers are laughing. They'll tell me that that doesn't exist, right? And it doesn't exist, it doesn't. But you can make it exist if you know what you're looking for, right? The last I can tell you. I've done two deals in 2020, one pre-COVID, one post-COVID, and in 2019, 2018, we've been doing deals pretty much every year for the last five and if you look on what generally performing at is a year one — and you can make an argument, it's not pertinent to the situation — but year one cap rate, looking back over double digits, we'll call it that, double digits. Cash-on-cash on primarily a cash-on-cash investor, 25% you know? I'm looking for a quarter of my down-payment back that year one. And I'm getting, I've been getting it.

I'm looking for a market with an exit, you know? I'll take some risks, I'll roll some dice, I'll take markets that others may have concerns about but I'm going to guide my exit through my entrance. Through my purchase price. My purchase price is going to be low enough and my income is going to be high enough where I know even if I have to outperform the cap rate on exit — if you exit cap rate in that market, it's six, I want to write a seven and a half, literally. Which is an outrageous spread as a syndicator. You'll never find a deal if you had a spread like that but for me, I can still do that, right? I know that even if that market may not be preferred at my exit, I'm in a position where I can offer such a high cap rate that it won't matter. Somebody will be greedy enough and sure enough, that happens. That happened.

I had 60 units which I purchased in 2014/15 for two million dollars, okay? In a market that — it was a military town. During the Obama administration, the military spending went down, the towns got hit pretty hard but through effective management, I was able to double the NOI. And initially I had a preferred deal that didn't work out but went to market and we found a person, I offered it at a seven percent cap rate which turned out to be 4.6 million dollars. You know, two to three years later, and somebody bought it. And they still hold it and if you can figure out your cash flow, if you can make your cash flow work for you, somebody will want that cash flow, right? They'll be an exit on the other end of it. Where I get sketch is the syndication model that says, you'll never have cash flow. Multi-family assets can't have cash flow. We're only going to make our returns on the exit, that alone, I don't buy that.

That premise alone, right? That premise alone maybe can work when you're buying stuff and half of rebuild cost and a nice growing market path of progress but in 2018, 2019, where you're buying a Class C asset, in a Class C neighborhood for more than rebuild cost than it takes to build an equivalent asset in a Class A neighborhood, right? You're saying, because I'm overpaying for this, because I'm paying a four and a half, five cap on income that's not even there, the income that I got to create and then have it in my exit that's got to be at such a low cap rate and I'm not going to cash flow during the hold. You see risk after risk and you don't have to invest that way, why do that? There's too many other, easier ways to make money, you know? The problem is as a syndicator, you have a lot of constraints. You fall into that model that you wouldn't do as an individual investor, right? Some of these syndicators are buying assets, I know for a fact they wouldn't buy if it was on their dime, right? They wouldn't buy.

They get stuck in these markets, they'll tell you, "My investors only invest in the three markets, that would be a market that has this kind of growth and this kind of rent appreciation," their metrics. You know what? Everyone's looking at those metrics, the same metrics, everyone's buying down that yield, right? Now, here we are on a correction and what we're seeing is that we're seeing multi-family rents, have not — that debt that everyone was bracing themselves for have not come to fruition. It's pretty much market [INAUDIBLE] right now, at least in Arizona — and I'm hearing it in other states that everybody's pretty much on track, fully collected, March, April, May. Everyone's having a party. They continue, "I'm still looking for assets, I'll still buy the same way I bought this for." That's what I'm hearing now, right? I think that's a fool's errand right there. I think you're going to have the small window in 2020 to sell whatever assets. There's a ton of funds that are very well capitalized, distressed asset funds, and they're going to overbid on the same group of assets and that's going to make it that much longer for the assets to clear out where they should have cleared out by the end of 2020 and it may take until the end of 2021 or 2022 to clear out. If you're the guy that jumps right back into the market, in the summer of 2020, I think in 2021, you're going to have some serious regrets.

I think that's – the riskiest proposition I think I've ever seen in my 10 years. Buying right now over the next 60 days I think is the riskiest proposition I've ever seen in my years of investing in real estate.

[0:14:09.7] WS: What do you foresee happening? what's going to cause it to be so bad a year from now for that person that's purchasing right now?

[0:14:16.9] SS: Well, I think that your prices haven't dropped. I think your demand is still there, I think the fact that the bad debt is what it is, it's going to lull a lot of investors and a lot of this money on the sideline, that multi-family is okay. I think multi-family is okay, don't get me wrong, I think that multi-family is relative to just about every other asset class right now but it's okay and is surviving, right?

But you have to understand that what's keeping the floor, what's keeping the foundation up, is irregular and temporary government spending. Hear me out on this. Irregular and temporary. The government's not going to pay unemployment benefits more than your tenants were making past July. They may extend it through 2020, right? But it's not going to be forever, we can't afford that forever. We can't afford that forever.

Interest rates, as low as they are right now, they're going to stay as low so you're going to have a low going into 2020, you have a low in 2020 that says, "Hey, incomes are okay. You can price multi-family based on a T12. You can price based on revenue growth, rent growth. You can price and it is normal." And that's going to lull this group of investors into buying something this summer, this fall, right? And it is going to seem like everyone is okay, right? But because of the government intervention and because of the money that was on the sidelines come March-April when this began, it is going to take that much longer to clear up and you are not going to see the pain until the tenants actually get pinched, which is going to happen in 2020. It is just a matter of time. There is no way the 40k, 50k earner that is all of our asset class or okay, you got a Class B plus and your guy makes 70,000 instead of 60, big deal. All of those guys, all of that base tenant class is going to get pinched. It just hasn't happened yet and so it is making multi-family look a lot better than it really is. See, in retail and in office, there is no place to hide. The government is not funding the nail salons. You know it does the P.P.P program or whatever but they're not capitalized where it is just happening a lot faster.

We are seeing the deals in retail, in office, coming through now without that floor but as soon as that floor drops in multi-family, there will be a correction and you know what? Here's a thing about multi-family, it doesn't have to be a 10 to 15, 20, 50% drop like 2010 for there to be a correction. It doesn't have to be. The only thing and think about this for a second, the only thing that has to happen in multi-family for prices to correct is for investors to demand what they should have been demanding from day one, demanding to purchase based on results. That's it. That's it, the only change you need is buyers to say, "I'll pay this on the T12, okay?" It is going to be based on the T12 and not on the broker's proforma, not on the rents you tell me you're going to get, not on the rents, maybe you've gotten approved and you've gotten a sample. Investors aren't going to continue to buy that way and you are already seeing that. You are already seeing that in the market. You are already seeing some stuff getting discounted. But what I am saying is there is going to be this short period low where investors are going to get conned into buying based on proforma and so for all of the investors that are holding asset that they're underwriting — selling based on a proforma, you know they'll get hurt and they may not even be a correction that you read about in the *Wall Street Journal*. There may not be articles about multi-family landlords going into foreclosure and bankruptcy. You may never see those articles but as sellers, as buyers like you and I and the majority of buyers say, "Hold up, I want to actually buy on what the seller has done." Which remember, is what it should be but you know, you talk to known investors. Guys like Ken McElroy and such, they'll tell you that they had stopped buying in the last three years because "I didn't want to pay a buy on proforma" And I have never bought anything on a proforma.

I have never bought anything based on a premise that I need to come in. Now I do my own proforma so yes, I buy everything on a proforma but I never bought on a premise where I am going to pay a cap rate based on future outcomes. I don't know future outcomes. I am not in the business of future outcomes.

[0:18:33.5] WS: That makes a lot of sense and you go on what information you know for a fact right now, not what you hope to be I guess. Yeah it makes a lot of sense and so ultimately you expect, right now, our tenants, our customers have received a lot of money that is going to tide them along for a little bit and then eventually, it is going to run out. Eventually they are going to have problems and then obviously then the owner is getting problems if enough tenants can't pay rent.

[0:18:58.7] SS: Yes, I don't see a way around that. I mean we can't subsidize this class forever. You are going to have people that drop out of the workforce permanently. I think your migration patterns are going to change, which we saw during the recession. I think your population growth with cities isn't going to experience what they experienced in the past. I mean it may hasten it certainly but I think caution is the ticket right now.

Caution, I mean the deal's got to be, I don't want to say, a slam dunk. Again, I am not expecting 2010, I am not expecting 2012, I don't think you're going to see foreclosures. I mean people have put a lot of money, people have repositioned properties, people have added value and people will pay for that value but people aren't going to pay for future value forever and that is going to change pricing.

[0:19:44.3] WS: How do you see this affect the properties, the hundreds of units that you have right now?

[0:19:48.1] SS: I never underwrote selling something on a proforma and funny enough, I have never fully been able to sell anything. I have sold multi-family as well. No one's ever come in. Somehow when I am trying to buy something, I got to pay a cap rate based on year two proforma and a million dollars in repairs. When I am selling it, no one wants to pay me that right? So I have never sold based on some outrageous proforma.

I have always had enough value-add in my properties and I have always bought them right enough where on exit, my value is there. I don't have to explain, I don't need a broker to say, "If you add washers and dryers you can have 50 extra bucks," or "if you just do something with the courtyard, you can raise rent 50 bucks," or "if you add a $200,000 gym you can raise another 50 bucks." I've never had a broker have to make that argument and I have never underwritten my exit on how you rate. But I have underwritten my exit that I bought it with $250,000 NOI, the owner didn't have RUBS, the owner was under market $50, and the owner was self-managing and making mistakes. So I have inherently 100 to $150 upon natural turnover. I'll do easy turns, I'll raise my rent a 100 to $150. I will control expenses and I'll go back to market with my NOI at 750 and based on that 750, pay a return, I am not going to go to market and say based on a $1 million NOI. And I need that spread just to pay my investors back, I want to pay myself back and if the property is performing and it is an easy property to manage and it is in a sub-market where I have other assets and it is super-efficient I am going to hold. Why would I sell a good performing apartment?

[0:21:32.4] WS: Yeah, well that goes right into — you had mentioned earlier you want to do it tax preferred during the buildup and during the hand off. I love for you to elaborate on that just quickly before we run out of time.

[0:21:42.8] SS: Yes, so as you know, while you're holding it. Year one you are going to do accelerated depreciations. So you are going to take all of the income and the gains you have made on your other properties that are already repositioned and cash flowing like crazy. You're going to — the one property you bought and did put the money into, that is going to go against your income in year one. So you are probably not going to pay much income, right? And you are going to do that through cost segregation and some of the new laws and the stimulus build. There were other goodies in there you can look into and then on the sale, you can either exchange it or in some cases like for me, I didn't even have to do an exchange. I just sold it. I repatriated the money and just bought another asset four months later. Waited on another asset as long as you buy them the same year, again you are doing these accelerated depreciation.

So these days you don't even have to do 10-31. It's that easy and it's like, talking to other investors, other asset classes, show me a more preferred asset class? Show me where you can do that, show me what you can make this kind of money and defer your taxes indefinitely or legally right? I don't know many other classes. If you can do that, right? And that is what I mean by tax preferred. But I do believe, I am not a believer in the philosophy that multi-family has never to make cash flow. You can never cash flow off multi. You are only making money by selling it to the next sucker. I just don't believe that. I just don't believe that that is how it's done. I believe you can make multi-family. I know you can make multi-family. I have done it but you've got to buy a certain way and you've got to take risks that are different than the risk that other people are taking. You don't want to be in a herd.

[0:23:13.7] WS: What's that risk that you got to be willing to take that other people aren't taking?

[0:23:17.4] SS: So for example, I'd rather take the risk of buying a 100 unit property for $5 million in a secondary market of say 700,000 or 1.2 million people. So I would rather buy on cash flow in a Tucson rather than a roll of the dice in Phoenix for example. Or Knoxville versus Nashville, right? If the spread is to commensurate. Now lately the spread has become onto measure. You can go to a secondary market and there is nothing there as well. It was good then but I see a lot less risk when — granted, the secondary market has to be a legitimate market. So I am not talking about a dying or dead market with no population growth and no job growth and nothing. The secondary market has to have it but just because it doesn't have over 1.5 million people, I can't invest there. I don't buy it, right? Again, I am looking for in-place cash flow. In place yield with me having to do very little and the brokers will tell you that that doesn't exists and I am here to tell you that it does exists.

[0:24:20.9] WS: And you find those deals through brokers?

[0:24:22.5] SS: Yeah, I have been building relationships for five to 10 years with a lot of these guys and a lot of these guys that were coming out of college 10 years ago are now running their own firms and in the small states, with two big markets. You got five companies, five guys running all of these deals and if you are finding a 100 unit on LoopNet, you know, a public deal that's been sitting there for months and months. It's been passed over and brought to guys like me and guys that will transact it.

So pretty much that is kind of the only way. If it is running its process over 30 days and you're competing, nah. I have never been able to secure a deal that way. I have never been able to secure a deal by competing 30 days — but again, you know I am not looking for what everyone else is looking for.

[0:25:08.6] WS: Sure.

[0:25:09.1] SS: Now if you are a syndicator and looking for a eight and a half to 15 and a half million dollar, 95 to 200 unit deal, every syndicator is looking for that in Phoenix or in Atlanta or in Dallas. You know everyone is looking at the same city, everyone is looking for the same assets, everyone wants that 1986, no boiler, no chiller, all the rooms are classy. Everyone wants that same product.

[0:25:34.2] WS: So you are finding something else, yeah that's interesting —

[0:25:36.7] SS: — No, I am finding that product. I am finding that product but I am finding that product with maybe a seller that wants certainty of close or a broker that is willing to give me a week to negotiate without running a 30-day process and highest invest or a broker that underwrites accordingly. There are some brokers in my market that I can't and will never transact with because their underwriting is so horrendous.

And I will argue with them and then finally just give up on it but they had been selling their deals. There has always been somebody selling their deals and today post-COVID, they're the only broker that is actually putting deals on the market because you got six dozen primary brokers, right? In Phoenix, in that row, pretty much all of them have nothing public right now. A few of them have some pocket listings and there is one broker, the one that I cannot transact with that has this listing, like six to eight listings. It has all the listings. Somehow they think that the thing is still going to transact and they are underwriting the same way based on peak wealth, based on them telling you how do I buy based on a Phoenix peak wealth, the height of a cycle when we are entering into a completely new cycle and I am going to buy it based on the height of the last cycle? Really?

[0:26:48.6] WS: Yeah.

[0:26:49.5] SS: And they're seller-buyers.

[0:26:51.0] WS: What's the number one thing that's contributed to your success?

[0:26:53.5] SS: You know keeping an eye on the future, keeping an eye on where I want to be and keeping track of fundamentals. Never swaying, you know it is very easy to get caught up. You know you hear a smart guy in a podcast tell you why you need to be investing this way or that way or in this city or through this lens and being able to say, "I'll stay true to myself and my investing criteria" while others may either criticize or take a sway or brag about how much money they made on an alternative. Of course, if you believe it and it's worked for you stay the course.

[0:27:31.9] WS: What's a way you have recently improved your business that we could apply to ours?

[0:27:35.9] SS: Good question. Going into alternative asset classes — being open to and going into different asset classes. I recently purchased something that was different from than I've done. So being open to different asset classes and being open to different investment strategies. And bringing your team with you. So you know maybe you've never done mobile home, maybe you do a mobile home and you grow with your multi-family, maybe you train your multi-family manager to manage a mobile home park for you. Maybe you buy a hotel, you know? You look at the good stuff.

[0:28:16.0] WS: Tell us how you like to give back?

[0:28:18.4] SS: I like to give back through knowledge and time, primarily. I am always open. I am always open if somebody wants to talk, I have young investors call me, honestly, weekly and I am always open. I will have a 40 minute conversation and a lot of times, these people don't like what I have to say. I am brutally honest, they don't like what I have to say and a lot of times, my advice would be that that is not an investment and you shouldn't be investing.

[0:28:42.9] WS: I'd rather you be brutally honest.

[0:28:44.8] SS: Real estate is not for everybody, let's be honest. It is not for everybody.

[0:28:47.3] WS: At least we know where you stand. Serge, grateful for your time and just grateful for sharing your expertise and the way you look at real estate. I think it is great that you're brutally honest as well, I love it and just sharing your deal criteria too and that you are still making it happen — that you can find those deals like that. Now I think it helps us to really check ourselves, right? Or am I looking hard enough, what is my criteria, have I let my criteria flex? Because I haven't found a deal in six months or whatever that may be. I think that is great conversation. Tell the listeners how they can get in touch with you and learn more about you?

[0:29:19.3] SS: Yeah, send me a line on BiggerPockets. I am available. I'm browsing the boards every once in a while and I love to talk real estate and help. Whitney, thanks for having me. I love your show, love your guests that you have on and I'll continue to listen here.

[END OF INTERVIEW]

[0:29:35.1] 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]

[0:30:16.2] 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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