EPISODE 640

[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 Leo Hefner. Thanks for being on the show, Leo.

[0:00:32.9] LH: Hey, glad to be here. Thank you very much for having me.

[0:00:36.5] WS: Leo is the manager of South Bend 7, a debt free, private equity real estate investment fund that buys and holds cash flowing residential real estate in the Midwest. He's experienced professional with a demonstrated history of working in the investment banking industry. Skilled in negotiation sales, forward and reverse mortgages, private lending and business development. He's a cofounder of The Mastermind Association with Dr. Greg Reid.

As a cofounder of the Mastermind Association and a certified mastermind leader of brain quest mastermind, Leo has had amazing opportunities to interface with some of today's largest business and thought leaders. Leo, thank you again, looking forward to getting to know you a little bit. You got to give us a little more about your background or real estate, how you got into this business and operating a fund and I'm just looking forward to this a lot. Give us a little more background, let's jump in to what you do exactly?

[0:01:30.9] LH: All right, you know, as far as how I got into real estate, I got very humble beginnings. I grew up on the north shore of Kawai over in Hawaii, my dad started out in property management, got my mom into it, he went off into sales. You know, I was raised on an island in the jungle with parents doing real estate.

All over the biggest clients ever coming over and you know, my dad's clients anyway, all had something to do with real estate. You know, I had a couple of careers before I got into where I'm at now but real estate was something I was always in and around.

[0:02:04.5] WS: Wow, raised in the jungle and your parents were in property management so you're at least you were involved a little bit, you saw how real estate worked a little bit or rental real estate. Maybe you could just explain this to the listeners a little bit and myself, you're operating a fund that buys and holds cash flowing residential real estate. Explain that aa little bit. What that looks like, what your all's function is?

[0:02:26.3] LH: Kind of where this started for me is actually in the last crash. You know, 2006, 2007, I was wrapping up a computer training center in Vegas and there was tons of opportunity but I didn't know the right people in order to take advantage of it then. I watched a lot of people lose a lot of wealth.

As I started getting into private lending, I was seeing where a lot of these people where their wealth shifted and it came from being over leveraged at the wrong time. Where they got into the buying, just the flurry of buy everything, just leverage it to the hill. In fact, I met a dude who lost 997 houses in Vegas over the course of two years.

[0:03:06.8] WS: That's - I mean, I can't even fathom that.

[0:03:09.4] LH: No, that's multiple foreclosures a day. What is it? 997, it's two years, that's over two foreclosures a day every single day for two years and when I was talking to them I'm like, "How did that even happen?" And it was odd because he wasn't really sure. He's like you know, "The bottom just fell out, I couldn't pay these bills and this and that and people started leaving and then I didn't have staff and then everything just kind of crumbled." He was leveraged to about 80%.

It was through our conversation where he kind of went, “Oh! I had too much debt.” That’s what it looks like to me but he wasn’t alone. I mean, just in over the next couple of years while I was doing private lending. I was seeing how the banks really were in the best place in a lot of – in all of us, in every loan they’re in, they’re in the best spot, unless they’re in second position. That’s what brought me back towards, well, “How do I buy rental real estate, how do I buy real estate and create a safe place for people to be able to park their money for the next crash?”

That was how we came up with South Bend 7. You know, it’s debt free, we have zero debt, we own right now about 35 doors, they’re all cash flowing, they’re all lower income, I mean, it’s that section eight where a lot of people shy away from. But we’ve had very little dip in our rental income during this whole COVID-19 issue. This is exactly where we wanted to be. I’m not losing sleep, I don’t have banks calling me, I don’t have investors calling me, we’re good. This is what we designed this for.

[0:04:50.6] WS: Nice. It’s interesting, to have zero debt. You hear everybody preaching in real estate, right? Got to have as much debt as possible using other people’s money, right? I guess, you probably hear it a lot, you know? People say well Leo, what if you just took 40% debt or 50%, you know? What’s your thought about that?

[0:05:14.1] LH: You know, it’s all about timing. And honestly, I don’t have a problem going to 40, 50 or even 60% debt. Once we hit the bottom. I’m not going to leverage up right now once we’re in the middle of a freefall and people think that we’re coming back out of this, we’re not. We’re just coming out of three months of lockdown but the financial ramifications of what we’re just going through are going to be felt for years. There’s no way it can’t be. At least, that’s how I see it. There may be people that argue with me but that’s okay.

Right now is not the time to be leveraged up, right now, it’s the time to get good sleep, not get gray hair and go out and find those investors that see the value in this and want to protect their money from the wealth transfer of Wall Street and just take it out of a riskier position. It’s a good time for us right now.

And then once we hit the bottom, we'll leverage up, we'll buy a lot more and then we'll spend the next five years paying that off down to a manageable point so when the next cycle comes through, we're good.

[0:06:17.3] WS: Tell us a little bit about your deal finding process and you know, how that works a little bit. I mean, I would imagine since you're – you know, you have cash to buy properties with, you can probably be pretty creative. What are some ways that you're being creative or finding deals?

[0:06:33.9] LH: Being creative in real estate is, it's an art and there's a lot of people who like all the real estate agents, they don't get it, you know? It's very cut and dry. You get into – There's real estate investors out there that know that you have to be creative and you have to solve problems for these people that are selling their houses or losing their houses and so, there's two ways you can come in and solve somebody's problem and get a house for a significant deal.

One, you can just charge in and take it and don't worry about the people who is losing their house because they had it coming anyway, that's why it got there or you go in and solve the problem. For instance, you know, I had a – I found houses that was for sale from a realtor and it turns out that I had bought a house from these people about six months prior and so now they're selling the rest of what they had and I'm like well, "I don't know why they're selling." So, I told the real estate agent, "Call them. Let's just call the buyer." Except, I was dealing with the buyer's wife before.

He gets on the phone, turns out, the wife just died of pancreatic cancer. She handled all of the books, all of the houses, he had no idea what to do with them, didn't even know – Had nothing, didn't know. Might as well just sell them. Instead, I gave him three options. This is what I'm willing to pay for them, flat out cash, here you go.

If you want to carry some paper, here's another option, if you're willing to carry more paper, here's another option or if you still want to get the cash flow, here's a third option. How much money do you need right now to handle bills bury Joanie and just be okay?

It was like $5,000. I'm like, "Okay. What if I gave you $5,000, I'll give you 50 grand I think the number was for these other two houses in the fund and now, every month, you will get no less than about 200, $250 a month. Well now you've solved your cashflow problem, you got groceries, you can pay bills, what do you want to do?"

He disappeared for a couple of days, came back and went, "You know what? That cash flow thing works really well." I bought $100,000 worth of houses for $5,000 in cash. Solved this problem.

[0:08:47.3] WS: My goodness, wow. Ultimately, you gave him some options. I like that, you know, saying here's what I give you and then it's kind of a yes or no or maybe they come back but you gave him some options. Have yo8u seen that work often? Do you try to give options like that often when you're negotiating?

[0:09:04.0] LH: I do all the time. I do work with realtors and there is a few that I work with that they know, I will go around them, I will go talk to the buyers but I will never cut them out of the deal. Now, they're trained to the point where they're like, "Hey, here's a house, I think it fits for you, here's the guy's phone number, let me know what you need me to do?"

I cut them right out.

[0:09:26.3] WS: That's relationship, right?

[0:09:27.6] LH: It is, because they can't understand what I'm doing because it's outside of their box. They don't want to because I'm the 1% of their clients that are solving problems not just going out and buying a house.

I like to think of it that I'm helping. I'm helping our investors, I'm helping the sellers, I'm helping the community because a lot of the houses we buy, I mean, they're lower income houses. There's a lot of people that because they're lower income houses, they don't have much money to put into them to even make them a decent house to live in. I buy a lot from slum lords who don't necessarily, who just got into the business, didn't want to be a slum lord, it just happened. Because they didn't own enough houses, they didn't have enough cash flow, they didn't have enough money to make these places good and then they get sick and tired of people always beating their houses up.

We buy a lot of these places, we fix them up, we fix them up to an FHA Section 8 standard and let people raise their kids there. You know, we push for a lot of them to have Section 8 because depending on what state you're in, there's different guidelines. I mean, Section 8 has the authority to remove somebody's benefits. Once you figure out how to do that, you can let your renters know, "Hey, you're Section 8, you're staying in this house, please stay as long as you want, don't trash my house, if you need something fixed, let us know and if you do trash it on the way out, we can penalize you for that. If you want to leave," it's like, what's that Motley Crue song? *Don't Go Away Mad (Just Go Away).*

[0:11:05.5] WS: Awesome. I love that and you're solving some problems for numerous people in that transaction, right? Including the renters, you know? The Section 8, you know, they have a good place to live. But tell us a little bit about the fund side and operating a phone, maybe some pros and cons and you know, the benefits of your investors have even in investing in this type of fund?

[0:11:27.1] LH: Well, it's interesting because we're an open-ended fund, which means that we have a pool of houses that we've acquired, when an investor comes in, they're buying into that pool and they're buying into all future houses that we buy because it's open-ended. What that does is every time we buy a house, we increase cash flow and we decrease volatility. By increasing the amount of doors, we decreased the volatility because of one, three, five houses are vacated that month, we've got more cash flow so it's not as big of a percentage hit.

Those peaks and valleys because how we pay is we pay out percentages of the cash flow received. It's not a debt, it's an equity fund so as cash flow comes in, we pay that cash flow out minus what we charge in order to do this for our investors as well as to keep an auxiliary account there so if there's any big expenditures that we've got money just sitting there ready to handle it.

[0:12:25.1] WS: Nice, it's interesting. I don't know that we've had anybody really talk about operating a fund like that, that's just open-ended and kind of over a long period of time. How does that work for investors investing say the first investor versus somebody that's investing after you've got 20 homes or I don't know, however much under management, you know, three years into it or whatever it may be.

[0:12:48.7] LH: That was interesting, you know, that was a bit of a learning curve. We started this as a Reg D 504, which essentially means that we can take anybody, the dude working at 7/11, the valet at the hotel, you know, doctors, attorneys, it didn't matter, anybody. Anybody could get in.

[0:13:06.3] WS: Any amount? No –

[0:13:08.6] LH: Any amount, yeah. If we wanted to make that exception, we could make that exception, you know? We pretty much, we had a bottom of $5,000 but we could only raise a million dollars for when we started the 504, we hadn't – they hadn't upped it to a five million cap yet. We started out in the 504 which was great. I mean, everybody was an investor, everybody was a potential investor.

And then once we fulfilled that, our SEC attorney, she's fantastic but on the other side too, she's a little aggravating because if you don't ask the right question, you won't get the right answer. And she definitely won't volunteer information. You know, it's an attorney, right? They don't want to be held liable for your bad mistakes.

When we got to that point, it was, "Well what do we do now?" Well, you start another fund. Then the thought of me having – I had a flash back vision of some friends of mine that they flip houses out there in San Diego and every house flip is an LLC. You walk into his office and there's a law library behind him full of LLC books.

That's not an 800-pound gorilla, that's a 4,000-pound gorilla. In California, you breathe the air, that's an $800 tax. I was looking at that and it just had that flash and I'm like, "I don't want to have 14 corporations, I don't want to have this ever-growing corporation issue." Because then what happens in a year, I've got this 504, I can now go out and buy houses for this one again. But now I've got this 504, I got this 504 open.

Well now I'm traveling to go buy houses, but who am I buying that house for? How do I figure out, I'm going to buy this house and I'm going to choose to put it in what fund based on what? Who do I like better in it? Who is – I don't know? "

If I keep this simple and I have one pot and I put all of the houses into this one pot with the fund then nobody can accuse me of playing favoritism with this awesome house that is doing really good and this one is not going good because I keep putting crap houses in it. I didn't want the brain damage. So, I have them rewrite. We did a Reg D 506(c) and we overlaid it on top of the first round of funding so that I could eliminate all of that.

You know and then there was some interesting variations there of how I was guided to set stock prices and I mean those are all just mistakes that I figured out later on and now all of those just overtime, those are just they are coming out because the first round investors they've been in for four or five years. They are looking to exit and leave, which is great for the second round because the first round was at such a stock price that they were getting eight to 12%.

But my second round were getting four to 6% but as the first rounds leave, my second rounds are coming up to that six to seven to 8%. So, the dilution is going the other way, which is fantastic and it is something that you live and you learn. You move through and to move through business and you figure out things and how to make things better.

[0:16:21.5] WS: Yeah, I was going to ask you a little bit about how that's structured or you know if it never ends, you know how do investors get out or is there some type of exit or a way for them to get their funds if they need them?

[0:16:34.4] LH: So, there are but you know because we're not sitting on a pile of money, we need to deploy. We do have some exit strategies. Once we're either going to grow the fund up to a portfolio size of a much bigger fund is going to come and swallow it up that is one exit and we continue to buy things at a 40 to 60% of retail discount, there is money there on the exit. That buys the whole fund out, everybody gets to go away. We start up another fund and if those people want to come and play, they can come play again.

The second option is when we get big enough, if we get big enough, if we don't get swallowed up first then we can look at the possibility of going public. If we go public, it opens up institutional money. I got people at CalPERS that say, "You know what? Once you get onto a market, we'll put money with you." But you got to be able to swallow $250 million at a time. We are not that big. So that is not a thing yet.

Then the other way you know, per the PPM, you can't get out until the exit. Per the operating agreement, there is four or five different ways you can actually get your money back out if you need it back out. So, we are set up and designed for a long-term investment but there are ways that if you are having malfunctions, you are having problems or just it's time you can go.

[0:17:55.0] WS: Are there tax benefits by investing in a deal like this or do those pass through to investors in a fund like this?

[0:18:01.9] LH: Actually yeah, all of our depreciation of the assets pass through. All of the cost of doing business are all passed through on the K1's. So absolutely, so where we see the cash on cash ROI is that six to 8% after taxes and after all the pass through, you're sitting at 10 to 12. So yeah, all of that passes through.

[0:18:25.2] WS: So, you mentioned a little bit about what is happening in the market right now and are you still buying houses right now, buying real estate right now? Are you waiting? What is your philosophy on some of that?

[0:18:35.2] LH: So, the way that I have been buying even at the height of the market, I buy like we're at the bottom. I mean a year ago I bought a house for $2,000. I solved somebody's problem, literally $2,000. I walked out of this guy's house told him he is going to have to pay me a $1,000 just to take it off his hands because there was a hoarder living there and it was probably the most disgusting house I've walked through. I mean the walls crawled with how many cockroaches we're in it.

It was horrible. In fact, I ended up having to buy an exterminator for all the houses within two houses of this house after we bond it because all of the bugs fled, horrible but I buy houses like that all the time. You know I bought a duplex a quarter mile away from Notre Dame at an auction for $28,000. I haven't paid over $30,000 for a house yet and our average rents are almost $800 a month. I look at a lot of houses though.

[0:19:32.1] WS: Yeah, I was going to say, give us a couple of tips on finding deals like that.

[0:19:36.8] LH: First of all if is a numbers game, you know I mean when I am out there on a buying spree I will go and I am up at 6 AM and I am looking at houses until 10:00 at night and I might stop to eat somewhere along the way and I have people that are showing me houses that come in shifts because they just can't roll with me and I will do that for days and I have on total overload and then but I take a picture of the address, the date, the time.

I take a picture of that then I take a picture of the front of the house and then I go through my series of pictures and I do it the same way every single time. So that once I get back to the office, I can pull that up and I can look through the information. I can pull up the proper listing if it was a realtor or not or the notes that I have made and be able to go through and then analyze each house based on what I have taken. So, you look at a lot of houses and then you try and talk to the sellers if you can and solve the problems.

The other way is talk to property managers. Property managers who deal with investors always have investors that are looking to get out but they don't want to get rid of their properties because it hurts their cash flow. So, work with them to see if you can buy the investors properties and then just leave them with the property manager.

[0:20:55.2] WS: What is your plan moving forward? Can you operate this fund and you'll be bought out and then you try another one like you mentioned or just continue to grow?

[0:21:02.5] LH: Yeah that is the plan. So, the plan is to keep buying houses, keep growing. You know we have already entertained a couple of offers but they haven't been big enough yet and you know, they've all come back, "Well, you double your size and we'll have a different number for you." So, the bigger we are, the more beneficial it is for the investors and you know as soon as we exit on this then you know we'll fire up another one.

[0:21:25.8] WS: What's the hardest part about managing a fund?

[0:21:28.1] LH: Not having a lot to do between – you know, when you are out looking for money is you don't have enough money to go buy houses that is the hardest part. Buying houses is fun, raising money for me, personally, that is not as fun. You know like going out and finding the deal. So right now, I am in one of those spots where I can't go buy. I need to raise money. I've got tons of deal flow but I can't quite go anywhere because I'm in California and they got us locked down. So, it is an interesting place to be right now.

[0:22:01.5] WS: That is. What is a tip that helped you to get past that? I know you said raising money is the hardest part for you, personally. What is something that helped you to get past that to get where you are at now?

[0:22:11.5] LH: Realizing that when you are raising money, it is not about me. It is about the investor and again, it is problem solving. What does the investor need? What does the investor want? And do I even fit that bill or what can I offer that would actually be beneficial to them? That is the biggest hurdle is getting out of my own way because I have something great. Let me ram it down your throat and tell you all about it and then forget to ask what they need.

So as soon as I flipped that script, it became a different conversation, a more pleasurable conversation for both parties and it's been very good.

[0:22:45.6] WS: Great advice right there. No doubt about it especially when you are learning to talk to investors. It is hard not to just – like you said, ram it down their throat, right? Push them completely away. So tell me though, any other way to say you are prepared for in this type of business that you have, operating a fund, buying deals like you are and I know with no leverage, I mean that is just incredible but any other ways that you are say prepared for a bigger downturn than what we are seeing right now?

[0:23:13.3] LH: Well, if all of the properties, if everybody moved out or stopped paying rent and all of our properties across the board, property taxes and home owner's insurance those are really my only bills. So, what is that, highest 200 bucks a month? It's nothing but we have enough reserves. We can pay that for two or three years. So, it gets worse than it is and no investors come in because everyone is scared, we're okay.

[0:23:42.6] WS: Yeah, no that is awesome. That's an awesome answer and to be in those shoes where it is like okay, I think it is really bad. I mean you got plenty of reserves to come out on the other side laughing. And so you know what is a way that you have recently improved your business Leo that we could apply to ours?

[0:23:59.1] LH: That is a great question. I utilize managers in the areas where I invest. I live in San Diego, I invest in Indiana. So, I am not there dealing with tenants and toilets. I manage the managers. So, you know I have a weekly call with my property managers just checking in. Sometimes it's like, "Hey, what is going on this week? Nothing? Great. How is the kid? How is the dog? How are you doing? How are you feeling? What's going on, what do you need?"

You know and other times it's like, "Well we got this." You know we have things to deal with and we've been doing it long enough with them that by the time I get to that phone call most of this stuff is already been handled. So, having a fantastic team on the ground where you are going to be doing business is key and you know we opened up Memphis at one point. I could not get a good property manager to save my life. I could not, I spent weeks on the ground interviewing and talking to people and I couldn't get it to work out.

I wasn't meeting the right people and you know we bought houses before we moved there, which is one very important lesson I learned is if you're going to invest in some place that is not close to home, show up there and develop the relationships before you buy houses.

[0:25:10.6] WS: Great advice and that is why you're looking at houses is as hard as you are going those few days like you were talking travelling so far you want to maximize that time while you are there.

[0:25:19.8] LH: Correct.

[0:25:21.5] WS: So, what is your best source for meeting new investors right now?

[0:25:25.1] LH: You know I am part of a Secret Knock, which is a thing from Greg Reid. I go to there, I do his thing all the time. I am friends with just a great group of people, you know Scott

Duffy, Ryan Long of City Summit & Gala, those are all places I would go and I would meet investors. You know Scott Duffy's mastermind. I haven't been there yet but a lot of the people that are there I know.

And the Brain Quest Mastermind. You know we have out that together just to be able to help people in the mastermind association. I mean all of that has been just very key. You know so how do I find new investors? I try to give back, you know be free with my knowledge and help because there is people out there that need what I have or what other, the person next to you has but you don't know the people need it unless they ask. You know you don't know what value when you got locked up in your head that's valuable to other people until you are in a scenario where people can be vulnerable and just talk about their business without ego.

[0:26:25.7] WS: What's the number one thing that's contributed to your success?

[0:26:28.8] LH: I want to say that, giving back, serving, solving other people's problems and not letting my ego get in the way.

[0:26:35.4] WS: And I always ask at the very end, how do you like to give back? Is there anything you'd like to elaborate on that or something else?

[0:26:41.7] LH: There is a couple of ways. I mean well, somebody pointed this out. I was on another podcast and they went digging through my Facebook and they're like, "Look, what is this picture?" It is me and my daughter, we are unloading a truck full of toys to give to foster kids in San Diego, you know? So, I mean it wasn't even the one to things that was on my radar but you know we do things like that. I mean once a week or so, we go out and give food to homeless people just around our areas.

When I am off in Indiana, you know one of the first places I'll stop is at Starbucks and I'll get a couple hundred dollars' worth of $5 Starbucks gift cards and as people are just doing nice things or just being cool people I see something, see somebody do something cool, I give them a Starbucks card. "Hey that's really cool, here you go. Thanks." You know and some of these areas where they're poor, there isn't a Starbucks in those neighborhoods. They have never been to Starbucks.

You might as well give it a try and then I started recently get into the habit of going to one of the grocery stores that are in those neighborhoods and getting a bunch of little gift cards. So, it's like Starbucks or the grocery store down the street. Most of the time they're like, "Dude I'll take the grocery store." I'm like, "All right.

[0:27:46.6] WS: Yeah, wow. That is awesome. It is awesome being proactive in that like going getting those cards and if you are thinking that way, you're going to be ready to give them away, right? You know that's great.

[0:27:56.3] LH: Absolutely. I am looking for that. I am looking for those random acts of kindness from other people in the world and then be able to just be like, "Dude that was awesome, here you go."

[0:28:05.9] WS: Wow, Leo thank you so much for your time today and giving back and just sharing how you operate a fund and what you all are purchasing and how you're investors work in the deal. I am grateful for your time and getting to know you. Tell the listeners how they can get in touch with you and learn more about you?

[0:28:21.0] LH: You can find me on Twitter, LinkedIn, Facebook just at Leo Hefner or you can email me at info7@southbend7.com both of those sevens are the number sevens. I am easy to find. You Google me, Leo Hefner, I think I am the first three pages.

[END OF INTERVIEW]

[0:28:38.3] 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]

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