EPISODE 795

[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]

[0:00:24.1] WS: This is your daily Real Estate Syndication Show. I'm your host Whitney Sewell. Today, our guest is Mike Zlotnik.

Thanks for being on the show again, Mike.

[0:00:32.5] MZ: Whitney, thank you for inviting me again.

[0:00:34.2] WS: Yes, happy to have you back on the show. Mike is a returning guest. He was on the show WS 130. We're talking about real real estate funds and just how they work. He was also a guest on the show WS 539 and just handling uncertain time from a fund managers perspective. Mike is definitely an expert in this space. So, glad to have him back and talking about some project that he's recently worked on, which it’s great timing for right now with everything that's happening and been happening over the last few months.

So, looking forward to getting into that, but a little bit about him. In case you haven't heard those other shows, which I would encourage you to go back and listen to, but he's been a debt and equity investor in real estate since 2000. He started his career and had spent nearly 15

years in the information technology field managing risk, business intelligence and quality of complex systems, software and processes.

In 2009, Mike joined Tempo Funding LLC as a managing partner and vice president of funding operations. Starting from January 2014, Mike assumed responsibility of CEO and has since founded TF Management Group LLC launching three new real estate investment funds, TF Investment Fund II LLC, Income Fund, and Tempo Opportunity Fund LLC Growth and Income Fund and tempo Growth Fund LLC, which is also a growth fund.

Under Mike's leadership, the company has seen transformation and growth, delivering strong returns for the fund investors. A couple things we're going to discuss today, he's going to take us through a presentation that he has. If you're watching this, or if you're listening to this, you can go to YouTube, you can see his presentation, we're going to try to talk through it enough where even if you're listening, you'll know what's happening. But just know that you'll be able to see this on YouTube as well. We're going to talk about a hotel conversion that he has been working on and he's going to give us some details about that where maybe if you know somebody or if you have a hotel and you're struggling, maybe there's a way you could convert that. But he's going to help us to see this current opportunity that he has worked on or maybe is going to help you to see opportunities and deals and hotels that you see struggling right now. Maybe you as the investor could go in and do what Mike is doing, but also talking about some funds and how he's used them to invest in this deal.

Mike, welcome back to the show. Let's just jump in, and maybe can give us an update of anything related to funds and what you've been working on. And then let's dive into this hotel conversion.

[0:02:55.6] MZ: Thank you, Whitney. It's a great introduction. I appreciate the opportunity to be on the show. And we're living in this COVID world. It's a strange experience. It certainly is something that we're concerned for our families and elder and sick folks around the country and around the world for that matter. And this COVID-19 is a terrible thing but it has created opportunities. What's most bizarre is that COVID has differentiated winners and losers. I hate

to use the word losers, but you know, if we're just using the economic terms, it has benefited some companies and some businesses tremendously and has heard a lot of businesses and companies as well. If we follow a stock market, in general, two-thirds of the stocks are down and one-third is up substantially. That's what has happened, just on a grand scale of things.

Now, let's talk a little bit about just one specific opportunity that COVID has created. So, it's very simple for this conversion of hotels to affordable housing. So, of all sectors, there's one sector that COVID hurt the most is hospitality. And it's pretty obvious. Some hotels are still doing okay if it's a get away from a big city type of a hotel, but otherwise, a lot of the hotels are just dysfunctional, the tourism is down to nothing, business travel is nonexistent or very, very slow. So, a lot of the hotels are bleeding and they don't have a path forward unless they persevere all the way to the end of COVID and come back to some level of normalcy. So, the opportunity is to convert into affordable housing many cities and towns need that. There's a critical shortage for affordable housing. So, that's the high level.

I have the slide, so I'm going to walk through the slides unless you have a specific question, so please jump in.

[0:04:36.7] WS: Yeah, let's go through some of it.

[0:04:38.2] MZ: We'll skip the wonderful disclaimer. So, again, what's the opportunity? The opportunity is very, very straightforward to acquire a hotel at a distress price. So, if you're a multifamily investor, I know you have a great show, you have a great audience in the multifamily investing sector. The opportunity is no longer to look for another multifamily asset but to look for distressed hotels. Approach the owner, find out what's happening. Is the hotel in foreclosure? Can you get a special workout deal on it? Can you buy from the bank? Where you can acquire the asset, you can acquire it from the seller through some commercial short sale, or a workout in conjunction with a bank or a bank for closing, perhaps you could buy it from the bank once they foreclose.

Generally speaking, banks want to get the monkey off their books because they have to allocate all kinds of loss reserves and foreclosed assets. So, they're willing to give a good deal to get the asset off their balance sheet. So, you can acquire a distressed hotel, generally speaking, there's no right or wrong hotel, there are what I call "conveyor belt" projects, kind of you can do one after the other, they look very similar. And there are prized assets, like a historic building, some location, it was catering to great business travel, the business travel is gone right now. So, you can convert it to multifamily, but it's a unique asset. So, those are different projects. This presentation will focus on conveyor belt opportunity. In other words, we already did one, and we have two more coming up just like this. And we believe we could do another dozen next year, possibly one a month. This is such a straightforward play.

[0:06:09.6] WS: Nice. You may get into this in a minute, Mike. What about just the location of this opportunity? How should the listener or the investor be thinking about that? Because typically hotels place at higher intersections or busy areas or places, obviously, where a lot of tourism is. Is that still the place where somebody wants to live as their apartment? How should we be thinking about that?

[0:06:31.5] MZ: So that's a great question. That's probably the most important question to think through feasibility, for a feasibility study for a multifamily affordable housing being in that area. Most of the hotels that position too well and not great candidates for conversion because they're too expensive. So, you could convert them to higher-end apartments, which is a valid play. But if you're looking for affordable housing, you're looking more for residential neighborhoods that have sort of one of these, I call them not low flags, but they could be under a high flag like a Marriott. But they are apartments like hotels where people go away for a week from home and maybe near college or University. This particular project that we're going to talk about in Winston-Salem in a neighborhood, just a kind of an average neighborhood, not a downtown type of hotel.

So, what you want to see is that hotel fitting in as an apartment complex in that neighborhood, and if that fits in and you could deliver smaller but more affordable products, then you have a recipe for success. You can convert a downtown hotel for sure. Business hotels are

dysfunctional right now, but the reconfiguration of the rooms may be a serious issue on top of that, what is the acquisition cost and redevelopment cost? It comes down to the numbers. We just did a project unrelated to this example, where it was redeveloped as an old hotel in Utah to a multifamily. And that project was started two years ago, it just finished. It was unrelated to COVID. And the project is very, very strong and the numbers are coming out about the pro forma. But that's the rare example and one of a kind of deals.

This opportunity, I believe, exists in the more residential neighborhoods where the hotels are just not placed great. They don't work at hotels there. Does that make sense?

[0:08:13.9] WS: It does. Yes.

[0:08:15.9] MZ: So, we will continue the process again, this is straightforward acquisition, conversion, obviously feasibility study, and then all the math has to make sense, leased up stabilized and then refi. And then you can cash flow the asset or you could sell, whatever you prefer to do. So, a very simple redevelopment type of project. Again, the opportunity of the high level, hotel demand is weak. There’s substantial oversupply. There's a shortage of affordable housing. Hotels operating at a loss, they're bleeding. And it's a way to relieve the distress and people can't take this bleeding anymore. And affordable housing isn't in huge demand anywhere you go. I don't know if you can find the city where there's an oversupply. Everywhere in the states is a great need for lease types of affordable hotels.

The key component if you invest, either you have to be a competent operator or you have to invest with a competent operator because it's a conversion. It's a redevelopment. There's work related to potentially zoning potential entitlements, making sure the hotels approved there. Some of them naturally, the zoning will allow for multifamily housing in some cases may need to be zoning request approval. Most cities will welcome it, but still, working well. And then this redevelopment work, this construction, so make sure that if you invest you invest with a competent operator and if you do it yourself, you know how to do the work, you know how to manage construction, because it is a project even though it's not heavy lifting, it is still work required.

Here's an example. So, Winston-Salem, North Carolina, we just invested in this project. We really liked the basic thesis. It's an 88-unit Residence Inn by Marriott constructed in ’86, renovated 2012/2013. So, it's not a very old renovation. It looks reasonable. You don't have a very modern kitchen. They look a little bit more classic kitchens but they're still kitchens. And some people like that retro view or the classic view. So, if you can redevelop without redoing the kitchens because the kitchen is a substantial expense, that saves on cost. And then you have to look at the rents in a given market. If you can deliver a product with the rents well below the market, then it's an affordable product. It doesn't have to be what is an affordable product. It varies by neighborhood. In a little bit nicer neighborhood that the affordability will be just as good as in a little bit lower income neighborhood because it's affordable for that neighborhood. That's the whole thesis here.

Again, has to be limited supply, this particular example, the property is located one mile from Wake Forest University and approximately six miles from Wake Forest Baptist Medical Center. And this particular one zoning allows for conversion to multifamily used by right and apartment like amenities pool, fitness center lounge and tennis courts. All those things make the apartment complex desirable. It's 49, half thousand square feet spread across 11 buildings, so you don't have any high rises. The hotel looks like apartments. I mean, that's what it looks like. It fits in the neighborhood right off the get go.

MSA again, Winston-Salem, is the fifth most popular MSA in North Carolina. It's a great area, very Steady Eddie market. So, I'm not going to read the whole thing here, but it's kind of a market we actually like. The next project we have in South Bend, Indiana. And then the next one we have in Texas in New Braunfels, Texas, San Antonio suburb.

[0:11:29.7] WS: What about just the renovation time and leasing time or until a property like this could be considered stabilized?

[0:11:35.7] MZ: Yeah, it's a great question. So, I'm going to cover the economics first, and then I'll answer. So, the short answer to the question is 18 months. From the time the project

starts until the time is fully stabilized, it's 18 months. Compared to ground up construction, we typically need two years from the ground up, this is a faster project and 18 months is pretty conservative. You can actually get there in 12 months. So, from zero to full cash flow in 18 months is not a bad setup. This particular one acquisition price is 4.6 million. Construction is light. As you can see, it's not a massive construction budget. We've invested in projects where construction is greater than the acquisition price, not here. This one is fairly light. You have 88 units, 750,000. This includes all our renovations internal/external, so it's not a terribly expensive budget. That's less than 10,000 a unit, it can really bring units to a fresh feel, make them look appealing, improve the curb appeal, without spending the family jewels. And then it's got a $550,000 legal other operating budget, operating capital.

So, total capitalization is 5.9 million. That includes all the debt service, all the reserves to keep the property afloat all the way to full stabilization. This project was structured with a senior debt of $3 million. There's also mezzanine debt at one and a half million. And then the mezz debt is 1.4 million, senior that is 3 million, just want clarification and common equity is 1.5 million. So, total capitalization is 4.4 million. And the target sales price obligation is just under 8 million on completion of the project.

So, if you look at it, that you're all under six, the exit price is at eight or refi value. And from the return on equity, it's $1.5 million equity that's projected to generate $2 million of equity creation. So, it's not a bad return, it works well on a five-year hold, that sells sooner that'll generate return even higher than the projected IRR. That's the basic economics of the deal. And as you can see, the apartments look like they already have kitchenettes, they have the stuff setup. So, the lifting is not that heavy. Just a couple of comments on the financial structure.

We invested in this deal from two different funds, because we have a growth fund, we have a growth and income fund. We try to match the investment objective with the type of equity or debt on a given deal. So, that deal, as I mentioned, had 1.4 million mezz debt and we took a position in the mezz debt of 700,000 from our camp opportunity fund. It generates 12% yield and a point and then the temple growth fund took a million-dollar position in a million and a half

total equity. And it does have a waterfall. We're not the sponsor, the sponsor has to get compensated for doing the work, very competent sponsor, but it has an institutional level waterfall, it pays 9% pref. Then there is a 75/25 split until 18% IRR achieved and after that, there's a 65/35%, split 65 to investors, 35 to the sponsor, and IRR on a five-year hold is about 21.5%.

[0:14:43.9] WS: That's really good. Would you say Mike that having two funds like this is really your way too of offering kind of like a dual class structure, which is becoming a lot more popular now.

[0:14:54.6] MZ: Yeah, I mean, what we do, having two funds helps us to do exactly this. So, underwriting is the same on the D loop. Us, we like to deal, we want to participate in the deal as much as we can while maintaining diversification. So, given the size of funds, we're happy to write that half million to a million-dollar check. But both funds are in about the same sweet spot zone. So, the growth fund needs higher returns, but it doesn't need the cash flow. That's why I took an equity position. The growth and income fund can do both, but today it's focusing a little bit more on income so it's taking a mezz debt position, generating a higher yield for its distributable income, because the temp opportunity distributes quarterly, it needs income, tempo growth doesn't care. If it doesn't distribute in the first couple of years, it just needs the best risk adjusted return.

So, the answer to the question is yes, having two funds help us negotiate the deals, help us work kind of optimal financial engineering, I don't know how else to put it. It just works with a sponsor to provide the best product they need to make it work for them as well.

[0:15:57.1] WS: Just a different thought, I was wondering about this type of property. What about just the management side of this type of opportunity, Mike, compared to typical management, we would have for multifamily? Is this going to be the same kind of property management company, that you're going to have to manage a property or opportunity like this, and even going through the renovation process?

[0:16:16.4] MZ: This is a, I don't want to quote nationwide, but a very experienced sponsor that we've done projects with them in the past. They have the capability to manage projects on a national basis. So, they have property management, they'll manage it essentially, sort of in-house without hiring a third-party management company. With 88 apartments, you can afford to have a rental office, essentially, you have a front hotel person, you can have a leasing person, on a property like this. Some of these operators try to achieve a kind of scale and have more than one asset in a given market so they can leverage the same person across two properties.

The short answer of the question, it's in-house property management, this is a very institutional level sponsor, because they have a track record, they have experience and we're investing in multiple projects with them, because they know what they're doing.

[0:17:09.5] WS: What's going to be a couple red flags for a passive investor in a deal like this, Mike? If they're considering investing with somebody that's doing a hotel conversion, what are a couple things that they should just quickly look at to determine if it's something they want to move forward with?

[0:17:23.8] MZ: Before I answer the question, I wanted to show this slide, because they answer your previous questions. It's approximately 18 months between stabilization, rehab and stabilization. You ask the question, and this project is a five-year hold, so there is a refi event upon completion of rehabilitation. So, just again, I think this is the last slide, I'm going to stop slides. So, red flags, I would always start with a sponsor, the way we underwrite the projects, we follow the same process and the way you can pick up red flags is by virtue of going through people first to find the people who you know, like, and trust. You can't start anywhere else. You really can't. You can't look at shiny objects. A lot of information on the internet, and you pick up some offering memorandum. That's the first red flag, you don't know who you're investing with, but if you do establish that, that's not easy. That takes time, energy effort to build trust and to find these competent operators. Once you find them, you eliminate the risk of incompetence, the risk of fraud, risk of having them charge too many fees, risk of improper

waterfall, all those things are part of underwriting but you start with people and they run institutional shops, they do one after the other, and you have to invest with them.

Sometimes you can't break through and get to them because they prefer to operate with funds like ours, then you can consider working with us. Put some money in our fund, what we do that's interesting is sometimes we have projects where we have co-investment opportunities. So, we'll put a million from the fund and if this will if this project was 4 million bucks, and we took a million-dollar position, we can send to investors, "Hey, listen, there's a co-investment opportunity, you're welcome to fund negotiating a little bit better terms, but you can invest in the same deal under slightly worse terms because then underwriting as big of a check."

It starts with the sponsor, operator, fund manager, whatever you want to call them. Two, you absolutely have to look at the deal. Just look at the economics of the deal. I do look at all elements, and we start with does the thesis itself make sense? In this case, it does. How confident are we in the pro forma? There's a lot of people who use pro forma as a marketing tool. That's probably number one kind of risk on projects, pro forma looks rosy, everyone puts together these wonderful documents, and then promises very high returns. Stress tested to see where they can overrun, cost overrun on time, what the numbers would look like if that were to happen. And they generally asked for the underwriting spreadsheet. If they give you just the pro forma document without the underwriting spreadsheet, and I can't test assumptions. I don't want to do that. I want to test the assumptions that they're using and see if they work out for me. So, a key due diligence review is the underwriting spreadsheet.

Also, take a look at what fees they charge, alignment of interest. Now, I'm all pro everyone making money. But I've seen sponsors charge a ton of money, hiding their fees, and then you don't know what's going on, and before you knew it, they made a ton of money up front, and even if things don't go well it's not an alignment of interest. Let me put it this way. So, the red flag would be if you see a ton of fees, you see improper waterfalls. So, what is an improper waterfall? It really depends, we're used to institutional waterfalls. The short version of it is, you've got to have a decent pref. There's no right or wrong number, 7, 8, 9, 10 pref and a split generally benefiting investors more than the sponsor. So, the worst splits they've seen this

50/50, with an 8 pref. But a lot of projects we invest in whether it has 12 pref, 20 if it's a big project, and in this case, as you saw, 9 pref, 75/25 until 18% return, IRR is achieved. This institutional split in a project like this. It feels like there's a pretty good alignment of interest.

Then risk adjusted return. One of the biggest problems with these unfair splits is the risk adjusted return is not right. Most people don't understand because the sponsor things go well, they take too big of a piece of the pie, and if things don't go well, well, that's the investor's problem. That's kind of my position.

We could go and spend an hour talking about underwriting, but red flags, just stay away from strangers, don't look at shiny objects, find out people who have worked for you in the past and continue to work. Success is a habit. It’s not a one-day thing. You either do it or you don't. You either develop the skills and then the habits and the experience and the knowledge to do this quality work or you don't. That's kind of the way I look at it.

[0:21:45.5] WS: No, that makes so much sense. I'm glad you went into that, Mike. And yes, we could spend a lot of time just talking about underwriting and different things. Maybe we'll have you back and just talk about that. But move into just a few final questions before we run out of time. Mike, what do you predict to happen in the real estate market over the next 6 to 12 months?

[0:22:02.2] MZ: Okay. So, the same answer I've given before I'm going to give you again, used to have a crystal ball, it broke, I can't find one for sale. But that aside, there's one thing that I believe COVID did really well for real estate. It did one thing, it's a terrible disease. But it did something, it essentially forced the Federal Reserve to take aggressive action to cut interest rates. So, interest rates are historically low and I do believe that they are here to stay. This accelerated the drop in interest rates, so interest rates are like fuel for real estate fire. It's supporting the markets. It feels like the markets will continue to do well into the next year. Yes, there's still some significant risks in the economy. I think the fiscal cliff risk is substantial. So, we're recording this episode, when the election, we don't know how this thing is going to go. We don't know how things are going to work out, but my hope is a substantial support

package for the economy. The economy needs further support. And if that package goes through, and the job creation is strong, and the economy kind of moves along, I believe it will be fine.

Certain markets may do better than others. Some of it is political, some of it is economic, or maybe a mix of the two. But it feels to me with this low interest rate environment, multifamily is one asset class that is likely going to do well. As long as the assets are – I call them, the B class, possibly some A minus, I will stay you know out of the C and C minus, if it is a severe recession, that asset class suffers tremendously. Other asset classes are doing fairly well. Look at investment projects that create forced appreciation, create value, so there is downside protection. But I don't see any terrible recession in the economy and real estate in particular, in the near future. It's more of how well do we recover from here? Do things get a lot better or do they stay in this? We're still in the middle of COVID zone for an extended period of time and as long as the government is writing big checks to support it, things will be fine. If the government stops providing support, we might see an accelerating recession.

I think after the election there will be a will to stop whatever political differences of pre-election fight, and now, we're passed the election, I think they'll come together to write some checks to support the economy. So, it feels like we are moving in the right direction, the interest rates and supporting real estate. That's the general theory. You could talk about this in specific markets. I'm in New York City and ask me, “What’s going to happen about New York City?” Commercial real estate, it's going to be in distress for a while, that asset class again, a very specific sub sector of the market. Now, residential is doing well here while the retail shops you know, downtown, Midtown Manhattan is suffering because there's no tourism, and there are no offices and employees coming into town. So, that's probably going to suffer for a while until this substantial post COVID full recovery. We can talk about this all day long.

[0:25:13.3] WS: Mike, what's the number one thing that's contributed to your success?

[0:25:16.7] MZ: I would say this, whatever you do, make sure you're in the golden zone. You have to be good at this, you have to make money, and you have to really like it. It’s a

combination of the three. Find that golden zone, something you're good at, something you really enjoy, and something that makes you money. So, if you can find that, whatever you do, you will not be working, you'll be kind of sailing along. So, I'm enjoying real estate, this is my fun, this is my journey. Find that and you'll be successful.

[0:25:45.0] WS: How do you like to give back?

[0:25:47.0] MZ: So, I tried to serve in different ways. You could serve in the form of writing some checks to those in need and continue to do that. Years ago, I was involved with the Starlight Starbright Foundation, helped some kids who had cancer and stuff like this. It was almost like Make A Wish Foundation but a little different. I try to help understand who needs kind of help every day, not help have a charity and do it. If they walk in the street and you see a person that they asked for – a strange thing, they'll ask you for some money, give them 20 bucks, don't give them 20 cents, or a dollar.

I like to just help folks who need development, they're learning real estate, from time to time happy to take on an apprentice and guide them and make an impact. They do help with some donations and people ask for help and as much as I can, I do what I can.

[0:26:36.5] WS: I'm grateful for how you've given back, again, on the show, to the listeners and myself. I appreciate you just going into a hotel conversion, an actual deal that you're working on. And I think it's great to have that in our wheelhouse or in our pocket knowing that, "Okay, if we see an opportunity like that, that there's that there's potential there", and really helping open our eyes to that, but then also just helping us to think about finding that golden zone and all of that.

But, Mike, how can the listeners get in touch with you and learn more about you?

[0:27:04.0] MZ: Thank you, Whitney. So, the easiest way to remember, people can go to the website, bigmikecall.com and schedule a time to chat. I ask you again, your time is precious, my time is precious, start with a 15-minute short conversation. I'll try to help as much as I can.

From time to time, I've had people come out with a range of complex questions and I will try to do my best to help you out. Again, bigmikecall.com, schedule 15 minutes, let's chat and see where you need help.

[0:27:30.1] WS: Awesome. That's a wrap. Mike, thank you very much.

[0:27:32.9] MZ: Thank you, Whitney.

[END OF INTERVIEW]

[0:27:35.1] 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]

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