EPISODE 988

[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]

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Whitney Sewell: This is your daily real estate syndication show. I'm your host, Whitney Sewell. Today our guest is Michael Episcope. Thanks for being back on the show, Michael.

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Michael Episcope: Thanks for having me with me, Whitney.

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WS: Yeah, I know. Michael and I discussed a strengthening investor relations to scale your business and scaling your syndication business on May the 25th. I encourage you to go back and listen to that show. That Michael has lots of skill sets in this business, they've grown an amazing brand and business, just in the syndication space and has many things we're gonna discuss today, but specifically about funds and how they have structured funds, how they operate funds, and just giving us some advice there from his expertise. But a little about him in case you missed the last show, is a principal of Origin Investments, co-chairs the investment committee and overseas investor relations, marketing and company operations. It reached 25 years of investment risk management experience to the company and believes that calculated risk-taking in inefficient markets is the key to building wealth.

Michael again, welcome back to the show. Why don't you just give us... I'm gonna encourage the listeners to go and listen to other show, 'cause there's so much value into that as well, and I know someone you're going to want to hear as they're growing their syndication brand and business and working and scaling their business, working with investors. But why don't you just at a high level, talk about funds a little bit, you know, what you are using funds for now? And let's dive into some of the details of how you all pick maybe certain types of funds or structured them.

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ME: Sure, absolutely. Yeah, I wanna comment too, 'cause it's funny hearing you read my bio there and calculated risk taking, and what that really comes down to is the rule number one, don't lose money in investing. And that's what it's about. We've been investing since 2007 - that's when my partner and I started the firm, and it was very quickly that we decided to structure things as a fund and a little bit different than a lot of syndicators out there and things... And the reason why we did that was, we just believe it's a better way to invest, it's better for us as managers, and I'll get into that, but it's also a better way for investors to invest as well because it provides diversification. You know, fund is really like a company as well, and you think about the managers promote and when you do individual deals, the manager promote is not cross-collateralized meaning...meaning great on one deal, the manager is gonna get paid, if you don't do well on another deal, the manager won't get paid but that net they do get paid on those deals. So in a fund all of those promotes our performance fees are cross-collateralized in one, so when we're really thinking about adding deals to the fund, there's a lot of time and effort and discipline that goes into that. And our whole team is compensated through the fund structure as well, so we have a credit committee that goes well beyond my partner and I. It's also all the team members who have a vested interest in the fund, and when people bring deals to the committee, what our acquisition officers do, those are scrutinized and they're heavily scrutinized because the wrong deal contain the entire funds, though from a discipline standpoint, there's a much higher bar for what gets into the fund because when you have 20 or 300 million in a single fund and one deal has the potential to kind of bring the whole thing down and bring you below that prefer return, it's a different threshold.

And then when I say it's better for us as managers, what I mean by that - I'm sure most people's minds are going to the fees, the fees are actually not any different, so we charge an asset management fee, in most cases, you're gonna get that on a syndication, will either charge a committed fee on that capital or an acquisition fee, and you're gonna get those same things on syndication as well. But for us, when we're going out to the market and we're competing for deals, the biggest thing is proving that you have capital. And when you come to the table and you are one of three, one or five, one of 10 investors who are looking at a deal and the seller is trying to qualify you and somebody's coming, "Well you know, we don't actually have the capital, but we can close. Trust us." That's not as good of a story and saying, "Look, we've got a 200 million dollar fund, we can close in 30 days" and in today's market, that's incredibly important to have that advantage, to be able to close quickly use the fund capital knowing that you have investors there who are ready to write a check for a deal that's approved within a box itself. So there are a multitude of advantages to a fund. I know some people don't like to give up that control. They like to actually pick and choose their deals, but I think understanding, you know, the benefits, the pros and cons of both is really, really important.

And the last thing I would add is sometimes it's not an "or," it's an "and." So we actually in our funds tend to use sidecar vehicles. So for deals that, you know, maybe are too big for the fine before we're only gonna put 15 million dollars of equity into the fund, but the deal requires 25 million dollars, then 10 million dollars, then goes to investors in a side car vehicle to fund investors generally had more favorable fees, so they can invest in that deal. But they can know investing in that deal that this has already been vetted by us, by the fund managers, this is something that we're putting into the fund, so really short cuts that, 'cause you've already made the decision to invest with us, with Origin in this fund, it most likely fits your risk profile, so those are actually advantages as well when it comes to even we're syndicating ideals and participating in individual deals.

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WS: So incredible there. Have you answered so many of my questions before I even ask them, which is great. But what you're talking about side cars, it's something I've heard a lot more about recently, and I think as more people are looking into fun structures and how to do this, it's something that's coming up. Can you speak though to which investor is going to invest in the fund versus the side car and why?

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ME: Well, believe in a lot of fund investors, I would say 80% of them are interested in sidecars...side car vehicles, 'cause for the reasons I just mentioned, they know that they've already been vetted - these are deals that we like, these are deals that we have high conviction in. And oftentimes, if somebody's putting a half a million dollars into a fund, they have more

money that they're willing to invest, so they're, you know, very likely to come in to a side car vehicle like this. So it's a large portion and what we found, more than anything is that this is gonna be a bigger part of our business going forward, and it's something that's in high demand and for the few deals that we have syndicated, the demand has been so overwhelming that it's difficult to give a piece to everybody because in our funds, we might have 3 or 400 people, and when you have a 17, 10, even 15 million dollar deal, those end up being fully subscribed within a day or two. And so there are a lot of investors who end up not participating because we generally do this on a pro rata basis, so we're gonna go out to our largest investors first and give them a piece and then kind of work our way down the reins. But, you know, what we found is that everybody really wants to participate that 80%. So going forward, even as we're concepting a new fund that's gonna be out or we'll be marketing in the third quarter, and then we'll be coming out with it in the fourth quarter, but almost every single deal will have a syndication component to it, so that investors can get a piece of those individual deals as well.

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WS: Okay, so just to bring some clarity there for the listener, so you're gonna have this big fund that will be purchasing numerous projects, right? And the investors may invest in the fund and they don't know the exact deals at that time yet. Right, they're trusting you all, they're trusting your group, they understand the risk level, those things, the type of fund that you're doing, but then the side car is going to be deal specific. Right, and so you have this deal or you're moving forward with, and then you have a side car that's attached to a specific project. Is that correct?

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ME: That’s a 100% correct. And, you know, I'll give some tangible examples. So we come out of this funding in fourth quarter right now, we're targeting 150 million dollars in fund size, and so what we're looking at from a risk management perspective about how to allocate and diversify across this fund, this will be a round of development, we'll have about 8 to 10 deals in there. And there's also what we call a GP sleeve - a general partner sleeves, so those are high margin deals where we are participating in the general partnership. But the other, you know, eight or nine deals that will be in this fund, we don't want any more than 10% of the deal in the fund. So if you're a typical around a multi-family development deal is 25 million dollars, and we're putting 15 million dollars in the fund that requires 10 million dollars of additional equity as that side car vehicle and investors are participating right alongside the fund and those. But when you add that up, that's almost 100 million dollars in syndication, so the net of it is the fund will have about

150 million dollars in committed to equity. Those fund investors will get the first look at those sidecar opportunities which will be about 100 million dollars, so in all, that's about 250 million dollars in deals that we'll do in that particular fund itself.

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WS: Were your fund to be 506 P, 506 C?

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ME: 506 C.

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WS: And then something... I've learned recently though, what about your side cars? Because they could be a 506 B then, is that correct? Or do you all do that?

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ME: Yeah, but we operate under the 506 C rules even in sidecars. So, you know, with those again, we don't market those per se on a broad marketing...is generally all of those sidecar interest, they get gobbled up by fund investors, so there's no reason for us to broadly market those. And it's usually an hour each by our investor relations department going out with the individuals in batches and letting them know about the opportunity. But nonetheless, you know, there's no reason for us to use 506 B when we can use 506 C. It gives us a little bit, which is, you know, more room to maneuver.

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WS: Sure. What about just the structure of the fund? And so, just so the listener can understand me, you can structure them almost any way you can think of, right? But some common ways, and I recently upper people talking about just like 70-30 split or some people call it like a 80-22, you know, like a 80-20 split, then it like a 2% acquisition fee or something like that, but how do you all structure that? How do you think through? How to do that?

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ME: Yeah, so you're talking about fees, and I think there's a couple of things. So in our funds, I'll start with the legal structure, if you will. So we have two funds that are already today, and then one that was down the horizon. With ouir funds today, we have an income plus fund that's more for the income-oriented investor that has about a 6.2% annualized yield, and then there's another called the three, 4% of appreciation that we're targeting that fund for a total return of about 10%. And that fund actually has a re-blocker in it, for tax advantages and then, but you're investing through an LLC. So, you know, for people who are investing in non-taxable accounts, the re-blocker helps with locking UBTI and it has under tax advantages which 20% deduction as well. In our QOZ fund, we do not have a re-blocker. That is purely an LLC that you're investing in, and that has some great tax advantages.

And then in the next fund that we're gonna be coming out with, there will also be an LLC, a limited liability corporation to which investors will get one, and I'm not sure if we're going to do a re-blocker or not in that fund, but we are talking about specifically fees - Whitney I'll get to that. In our income plus fund, what we charge is a 1.25% annual asset management fee on that fund, then a 10% performance fee. Now, the advantage that fund is, it's open-ended, and so when investors are coming in to that fund, they're investing all of their capital at once and they're diversified across the existing deals in that fund. So it's a little bit different than closed and fund where you committed your capital and then it's called over a period of time, and there's a big advantage to having all of your account there working at once. And that fund is then the mark to market on a monthly basis and dividends are provided on a monthly basis as well. If you don't want to dividend it, you can enroll and drip, and you can just re-invest those along the way. And then in our QOZ fund that is purely grown-up development, that is also one point...I should forgot...I think it's 1 and a half or 1.25, a little the higher number, so people don't call me out. It's still a good number. 1.5% and then a 15% performance fee, and it all are performance fees. And the thing about this market is, it's kind of all over the place where people charge fees, and I understand this. What you have to look at from an investors really compare the gross to net, so you look at it what it is at the end of the day if two invest with the managers are saying, "Look at the end of five years, you're gonna double your money." Right? That's the pro forma. Right, let's throw that out, how accurate those are for a second? But what matters is the gross to net.

Right, there's always going to be fees, and these funds, we have a team of 30 or working on behalf of, you know, almost 1,600 investors, so our fees are annual asset management fee. In some cases, we do get an acquisition fee. In some cases, if we're structuring a fund, we might do a committed fee, but in fact, this fund that were coming out in the fourth quarter, we've actually decided to go away from the committed fee after talking to our investors, because they would much rather have the variable cost of an acquisition fee than the committee fee. And what a committed fee means is that if you wanna close that fund and you commit a million dollars to the fund, you're paying whatever that annual committed fee is from the day that you make that commitment. So it's 1.5%, you would be paying that manager $15,000 a year starting on day one. If you look at it from an acquisition fee standpoint, then you're only paying once the manager finds a deal, right. The fees generally come out to the same as long as there's a velocity of capital, and the manager is doing their job. If we're doing our job and putting out capital and, you know, call it two, two and a half years. But if we're not, then the risk falls on us and not the investor. So that's always a risk of investing in a fund. You committed a million dollars and the manager can only put out, you know, 6 or 700,000 dollars and you paid fees on the whole thing. But the way that we're operating, you know, going forward is we'll just try to create better structures more friendly to investors and meeting the market demand and continuing on our structures going forward.

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WS: No, it's awesome. I appreciate just you elaborating on that, 'cause I think a lot of this is new to many of these newer upcoming operators that are listening and many investors to that I know, listen to the show, I get questions every week about funds versus not doing funds or, you know, single asset funds versus open funds like this. Can you just speak to the investor though? That's the passive investor that's thinking through maybe the tax implications between, say, your income fund versus, you know, QOZ fund or, you know, other types of funds. What are a couple of things they should be thinking through? Is they're seeing more opportunities to invest in funds now versus single asset deals?

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ME: Yeah, so we've done a lot of education on this too. We have a blog, we've written over 400 pieces of content, and I would say that our strategy is really evolved in the last couple of years. And one thing that we've fundamentally changed is that we moved from a buy, fix and sell strategy to buy, fix and hold because as we look back, you know, what do we do? Right, we did...our funds did great - they're the top decile, top quartile performance, but even the deals that we sold, we couldn't replicate those today, and in real estate and really in the investment class out there, true wealth is built by buying, building value and holding great assets forever. And so when we're looking at, especially in multi-family, you've seen a huge run-up in prices, replacement cost, etc., our income plus fund is designed as buy, fix and hold. Our investors in that are typically accredited investors, their high net worth, ultra high net worth, family offices,

registered investment advisors as well. And in that fund, it's a three-prong strategy. So we have preferred equity, we have a core plus sleeve, buying existing deals, holding on to a portfolio of really irreplaceable assets, and then we're also having 20% well quality frontier sleeve which is for ground-up development, and ground-up development is not a bill to sell, but it's a bill to core. So in that particular strategy, we're building a market, it's like Phoenix and Nashville because in those markets, it's nearly impossible to buy. There's so much capital that is chasing deals and paying well the band replacement cost, and we just see that the advantage there is to build in ground-up to penetrate those markets and a better basis than what you can buy for today. And in our QOZ Fund the way that one works is that by law, investors have to be in that fund for 10 years and a day, and that's really a build to core fund as well, because QOZ law requires you more than double basis of the investment, which verily means that we're doing ground-up development in that fund. But ultimately in about three years, we'll have a portfolio of Class A properties located in some of the hottest growth markets in the United States, and we'll be holding that for the next six, seven, 10, 20, even 30 years, depending on how long you wanna stay in the fund.

So real estate is incredibly tax efficient, but if you're not in it for the long run and you're gonna buy, fix, sell strategy, you're flipping deals. You're not taking advantage of two of the most important things in real estate, which are depreciation to shield taxes that passive income, and in today's world where you have tax rates going through moon, it's really, really important. And then the other one is the ability to refinance tax-free over and over and over again. And that's something that if you're going to sell an asset and you're gonna flip out of this, well, you're not taking advantage of those. And on the flip side of the coin - I talk about this a lot, you're paying taxes, so you're reinvesting in a much smaller portion of your capital, and then you have something called cash drag, which is when you sell an asset and while it sits in your bank, and you have to wait three, four or five months to reinvest that, that also has to be included in your calculation of returns. And a lot of people forget to do that, and so the way we've structured like the income plus fund, we want all of the money to go in there at once. These are funds that I use, my partner uses, we have almost, I think 8 million dollars collectively invested in the income plus fund. We have 10 million dollars on QOZ. So we have same and we create funds that we wanna invest and manage our wealth, and then that's exactly what we do.

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WS: For the operator that's listening right now that's fixing to pursue their first fund, what are just a few things, Michael, that maybe you wish you had known when you all did your first fund?

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ME: You know, I would say educate investors how to buy, fix and hold strategy. I listened to somebody in Chicago. His name will come to me, but I remember years ago when he started a Chicago icons name is Dan...Oh, I forget the last name, will probably pop in my head in a minute. But he gave an example many years ago, and he said, "Look, we used to be in the buy, fix and sell business and...and what we realized is that we're making great iron but we were building a irreplaceable real estate." And he gave a couple of examples and he said, "We build a multi-family residential tower in San Francisco," and you know, the numbers he gave...he said, "Look, we put...bought it for 10 million, we put 5 million into it, sold it for 22 million dollars." And he said "The real money was made by the person who bought it for 22 million dollars" because you know, at the time, this was 10 years later, we all know what's happened to San Francisco, but it's really a story about your irreplaceable real estate. He said "That property today is worth more than 100 million dollars." What I took out of that, and it was really sort of profile at the time, is that when you've already mitigated the downside risk and you have protected investor's capital and you maybe send some money back to refinancing, maybe not all of it, you should be holding those assets, and you have to educate investors on the difference between IRR and multiple un-invested equity.

In real wealth, again going back to the beginning and tying this together, is made through buying and holding great assets forever. It's not by buying and flipping out of great assets and letting the next person do that, and you can...you know, countless examples, and I'm sure there are people going "Yeah, but you, you know, can never, you know, go broke taking a profit." Yeah, I don't know. That saying it's great, but it's not actually true, and you can apply this lesson to the stock market, to real estate, to everything, and there's the old saying that I subscribe to, which is "Time in the market is far more important than timing the market." So as long as you have the right amount of leverage on these deals, it's great irreplaceable real estate, we manage your risk, you should be holding these deals and educating your investors on why it's important to hold these deals, because deals that are making to act to be hold them for another five or six years, maybe they make four times on your money - five times, six times. So that is a lesson I would say that everybody needs to learn - stop marketing IRR and start marketing the wealth that you can create for investors, 'cause that's what matters.

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WS: So well said. I love that. That's incredible. Did you call it IRR versus you say multiple invested equity. Do I hear that correctly?

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ME: Yeah, multiple un-invested equity. And that's something, you know, years ago I was educated on I think when I first came in to the investing world. I was at a conference and I heard manager talking about that and saying, "Look, you can't really measure IRR right in terms of wealth." Somebody said, "Give me a million dollars selling you a 15% IRR," you don't know what that means, right? Because it's a time-based function, so it could be that you invest a million dollars on day one, they give you back 30% of your money four months later, they gave me back 30% of your money 15 months later, and you have this giant IRR, but then your multiple un-invested equity, which is simply defined as if you get a 1.5 multiple and you put in a million dollars, that means that you've made $500,000, that 0.5 on your money, that is measurable. IRR on the other hand is time-based. It has a purpose, it's the best way to measure for funds that have erratic flows of cash flow, but you have to use them in balance, and a lot of times people are looking, "Oh, I don't want to invest in that because it's only 11%." Well, let me tell you something, 11% over 10 years is a lot of wealth. And I would challenge investors, look at your portfolio and say, have you really ever made 11% over, you know, annualized component rate over a 10 year period? Because if somebody told me that, "Listen, I've got an investment that is risk-free, that will make you 9% a year, compounded annual over this period" I'm in. It just doesn't exist out there, and so, you know, there's a lot of this chasing 15% IRR but you buy...you know, you're selling it, your taxes to your cash drag, etc. And I think you're much better off going into a lower IRR annualized return, right and looking at the multiple, something a little bit lower risk, but keeping your money working for the long run.

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WS: Talk about it, and I think it's so smart too, just the importance of educating your investors on this, right? And so many investors that you speak to every week and they have many basic questions - are wanting to get into this space, maybe they've been in the start market, they've been in other things, and they're trying to learn about syndication. We're almost out of time, but what are a couple of tips for the best way to just share these thoughts with investors to really help them to understand what this way of thinking is so important?

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ME: Yeah, yeah, I know, that's a great question. So we have a saying, you know, when you're explaining you're losing, but the reality is that we consider ourselves educators, and we want people to fundamentally understand this because this is the way that we invest our own capital, this is the way the most sophisticated investors, family office, pension funds, endowments invest their own capital. So there is an education component to this to, you know, get the market place to kind of rethink the way they analyze the view, and so we've written more than, again, 400 pieces of content on this subject, and everything I talked about here today, I've written something on it, or somebody in our firm, and we set out an Origin Insights newsletter bi-weekly with new articles on there. You can subscribe to our newsletter and you can go onto our website, and we have everything from education 101 in real estate, talking about IRR multiple to what is core plus real estate, what is opportunistic, what are fees, what is a reasonable fee structure to even how to get your manager. And it's kind of interesting because this is like a step-by-step guide. I think I wrote it five years ago, but we get call all the time where people are using this step-by-step guide and asking, you know, the questions that they really need to ask to understand whether or not they want to invest with us. And it's great to see that that is actually a tool that people can use and something tangible.

So educating is just, it's in our DNA and something that we feel really passionate about it. And so opening up this market and making sure that people know what they're getting into. And a lot of this is born out of the fact that I made my share of investment states, and I don't have to sit here and act like I've never done that in my life. You know pre-Origin...one of the reasons that got me to Origin was that I sort of got, you know, sort of two steps forward and one-step back all the time, and I got together with my partner, we created a team. It's a much better environment when you have a lot of smart people making decisions out there and seeing a lot of deal flow, and so it's really something that my partner and I have always felt strongly about is like, "Hey, let's help the individual investor, even the high network, the ultra high net work, really take advantage and get the greatest benefits of real estate." So by us writing about this and educating people, whether or not they invest with us or others, they're just gonna be smarter investors, and I think the entire market has benefited from the educational resources that we create.

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WS: For sure. Michael, even today you've provided so much educational content, just in what?

25 minutes or so. We are very grateful for your time and your experience. Unfortunately, we are out of time. But you know, in listeners, I would encourage to go back and listen to Michael's previous show, we're asking all the typical questions, you know, that we talk about, and just daily habits or how they're meeting new investors and things that's contributed to his success, but I'll also ask you, Michael, how do you like to give back?

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ME: So I am involved...I think from a real estate perspective - not I think - in a real estate perspective back in my master's in real estate from DePaul, and I've been a sustaining board member there for the last 10 years at least, so you know, that's one way I go back to the real estate community of definitely mentored many DePaul students coming through that program as well. And then, you know from a personal standpoint, my wife and I have a donor advised fund and we can donate into a multitude of charities, and it's just, you know, the world we live in. And I think it's important to give back and continue to do that.

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WS: Michael, again, grateful for your time and just going through just what a fund is today, whether you're a passive investor or whether you're an operator. I know this, the show has tons of value for you and Michael, just how you structure the fund, whether it's your income plus fund versus the QOZ fund, and I mean, numerous aspects of it. They're grateful for that time. How can listeners get in touch with you and learn more about you?

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ME: Well, they can go to our website origininvestments.com. We make it very easy to download our documents there. You can check out any of our funds, learn about us, learn about our track record or history, and you can also connect directly with one of our people in investor relationships, one of our team members there. So very simple, and then my email address, if you wanna get in touch with me directly, I can always direct you to the right person, it's michael@origininvestments.com.

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[OUTRO]

0:28:32.0 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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