EPISODE 1444

[INTRODUCTION]

Philippe Schulligen (PS): We decided to work with an equity partner. And I think it was not wise for us to have this new business plan all together on this larger deal. And while we were led to believe that we had several backups at the several layers, when we came close to the closing table, a few weeks away from closing, the equity partner bailed out on us. And we ended up having no real backup. And several partners, including myself, lost a significant amount of earnest money on the deal.

Whitney Sewell (WS): This is your daily Real Estate Syndication Show. I'm your host, Whitney Sewell. Today we have back our guest, Philippe Schulligen, with over 2400 plus units, and a $140 million portfolio, he's contributed to help raise over $29 million from investors. So we're going to dive in more about syndication and some details that whether you're active or passive, whether you're interested in a multi-asset fund or single asset fund, we're going to cover that over the next day or so.

[INTERVIEW]

WS: Philippe, welcome back. I'm honored to have you on and to continue segments into syndication, what is syndication and some details that aren't talked about enough, I feet like or at least the details. I appreciate your time yesterday and diving into your story, getting started in this business, having that coaching mentor or somebody and the benefits that came from that. But then the speed in which you got to 80 units and then 180 units and just so quickly. And so just grateful for you just sharing about what real estate syndication is. But I want to dive in more today and even deeper into the responsibilities of the syndicator, the investors and even how they profit from syndication and talk about the structures of some of these deals a little bit. And so I know the investors who were learning yesterday, whether they're active or passive, you're gonna learn a lot more today and tomorrow as we dive in. So, tell us a little bit more about the responsibilities of the operator that we should be aware of. And then let's dive into the responsibilities, potentially, of the investor as well.

PS: Yes, sure. Thank you, Whitney, for having me back. So, the responsibilities of the operator is going to range, it's anything that is active on the deal. It goes from you finding the deal, making the underwriting, putting the deal under contract, and then doing the due diligence on the deal. Obviously, you want to make sure that your business plan or the business plan that you're going to develop is confirmed by getting an estimate on different expenses. You're getting quotes for insurance, for repairs, et cetera. And also look at the different rents in the market, look at sales comps you want to firm. The sponsor is going to firm up their business plan at that point. And usually, by the end of the due diligence, they're going to make a decision. Are we going to close on this deal? All our assumptions have been confirmed. And is it a deal worth presenting to our investors or not? So, it's a "go” or “no go" decision.

PS: But by that time they will have studied the deal probably for between 15, sorry, 45 days they will have spent day in, day out looking at the deal, at the different aspects of the deal, working to deal with contractors, with a property manager, etc. Build a team with the lawyer or the lender. And then it's time, when the decision is made to go and close on that deal you're going to work with the lender, send an application for getting a loan, and so on. And start work with your SEC lawyer to do the paperwork, the private placement memorandum and the operating agreement for the company. And then you're going to present the deal to your investors. So it's typically, it could be a webinar, or could be a recording, or just some kind of PowerPoint. That's how you're going to introduce the deal. And spread the word, right, and we'll send some emails, text messages and whatnot to the investors to get their interest. What the sponsor will do is really show the highlights of the deal there. Those are the type of returns, those are, why do we think the market is a good market? This is why we think this deal, the business plan on this deal is very likely to succeed.

PS: So, that would be pretty close you're going to receive the money from investors put in an escrow account. Until the day you close the real estate transaction. And once you close that transaction, you will have your property manager take over the deal. And after a few weeks, you'll be able to see how the deal is doing. You will send updates to your investors and distributions, right? I mean, that's why we're doing these investments. The sponsor will oversee the asset, and that's what we call asset management. That's another responsibility of the sponsor. So fast forwarding to the disposition phase or to let's say they will be a capital event eventually. So, the capital event could be a refinance. To the sponsor, obviously, we'll work with the lender to get better terms on the loan and be able to get some cash out that we can send to the investors. Or it's purely and simply a disposition. And often what happens is by improving efficiencies, during renovations, you're going to increase the net operating income of the deal. And in commercial real estate with the cap rates, it will directly and proportionally increase the value of the deal. So you will be able to capture a huge part of the returns at disposition.

WS: Sounds like the syndicator, the operator has a lot of responsibilities, right?

PS: Right.

WS: I mean, I would say that's even a short list right there. Of all the things the operator has to be doing and juggling are their team has to be responsible for and be experts in, right? I know, I personally am not, would not claim to be an expert in all those things you just mentioned. But I do have to have people on the team that are, right? And that's what makes an amazing team as well. And I think that even goes back to the conversation yesterday about do I have the skill sets to keep buying single-family units or doing all those things myself. Could you do it? Yes. Is that the wisest thing for everyone? Probably not. , when you consider the time invested and all the things that Philippe just mentioned, are so much time? So, but I want to move on, because there are a couple of other things that I want us to have time to dive into today. But what about the responsibilities of the investor? Anything they should know, or responsibilities for them as they invest passively in a syndication?

PS: So there's a legal aspect which I can touch on in a minute. But first, I would say the responsibilities for the investor is like, we've mentioned yesterday, you have to vet the sponsor, right? So get to know the sponsor, and look at their track record see what kind of materials usually they'll have blog posts, they may have some videos, or podcasts and whatnot. You want to know them, what they're about. What are their values? Again, what's their track record? What's their *why*? Are they there for the money? Or they have like a larger purpose? I think typically, if it's only like, they talk about money, money, money, that could be not necessarily a good sign. So that's vetting the sponsor.

PS: Then you want to take a look at the deal. And it's good to look at the typical, what type of returns are you looking at? What kind of splits between the sponsor and the investor? Make sure that your interests are aligned, between the sponsor and the investor. There are some cases if there's a pref return, for instance, in some cases, it might make sense for the sponsor to sell or refi as soon as possible. But is it optimal for the whole deal? There are some questions to be asked there or at least understand. Have that discussion with the sponsor about what they do.

PS: Now, on the legal side, the investor has to review the private placement memorandum. Then they have to, obviously, like we mentioned earlier, there are a lot of pages, but I think once you've read one they're all pretty much similar. So I will do the exhaustive exercise one time. And then you can focus on what's important, like the splits, and preferred returns and hurdles, if any, and so you'll have to fill a subscription agreement, as well. And finally, you will have to wire your funds. Those are your responsibilities. And just stay on top of the deal by reading the monthly update. And ask questions, if any.

WS: Many great points there for just that LP or passive investor needs to ask about right ahead of time. I love how you brought up the PPM, the Private Placement Memorandum. That document that you mentioned has all those risky possible outcomes. It's just to ensure that, hey, we both know there's risks to any kind of investing. People say, oh, is the pref guaranteed? I say, well, absolutely not. I say what investment have you ever made where it was guaranteed, right? I don't know of any.

PS: Exactly.

WS: Right? And none. We 're all trying to reduce risk as much as possible and that document helps to just ensure that, hey, we both know the risks of everything that could possibly happen, but it protects us both as well. I think you mentioned, it's like spending the time at least once to read through it. Yes, 100-plus pages. But you're going to be so much better educated about how these deals work. Because of that, and then you're going to learn, hey, go back and next deals you may not have to read all of that. So much of it is the same. However, you do need to look at things like how are the distributions handled. What is that process? It will lay out exactly the distribution flow of who's getting paid first, down. I mean, many layers, right? You need to see that as the investor. What happens if there's a capital call? Who's in charge? Or what happens if that person, unfortunately, gets killed or dies? Who's in charge then, right? And you need to look at some of those things and ask them those questions that Philippe has laid out here.

But, Philippe, you also mentioned, you talked about the structure a little bit, and let's dive in there a little bit. How does the passive investor look at the structure? How do they choose that syndication structure that maybe makes the most sense for them? And maybe talk about a couple of different ways that maybe a deal could be structured?

PS: Yes, sure. So from a structure standpoint, you have the typical, very basic structure. You're going to have a split of the returns between the general partners. So, as we mentioned earlier, with all the responsibilities, the sweat equity and the limited partners. So, it could range from a very basic 80-20, it could be 60-40, and anything in between, or even better. So, 80-20, for instance, it's 80% for the limited partners and 20% for the general partners. But depending on what type of returns, the general partners might decide, anyway, still makes sense for the investors to have a larger share for them. But then you have other types of returns that can be added such as a preferred return. Now, the preferred return, the way it works is, if you do, for instance, an 8% preferred return is that before you do the split that I mentioned earlier, you will give the cashflow would go to the investors up to 8% year-on-yearly basis to their investment. So if you invested $100,000, that will mean that you should get $8,000 on any given year. And if the deal doesn't have enough cash flow to generate this amount of money, that is going to set aside, whatever is missing will be set aside and will be paid at disposition.

WS: Yeah, now. That's great. That even brings up even a point to the last point about the PPM. Like, you need to look at those things, right? What happens if they can't make the distribution?

PS: Absolutely. How's the money going to be set aside? And when are you going to be paid? Absolutely. And the other thing is that, from a structural standpoint there are also hurdles that could be made, meaning that the split may change once a key metric is reached. Such as, it could be, for instance, the sponsor has doubled investors' money in a particular timeframe then anything up to that point, the split could be 30% for general partners, 70% for limited partners, but above the 2x equity multiple doubling the investment money, it would go 50-50, for instance. So that's another structure on the splits that is possible.

WS: So what feedback do you hear from investors, Philippe, from that right there? Should they be discouraged because their split is getting less? Or should they be okay with that?

PS: I think they should be okay with that. Because I think that's probably the ultimate way to provide an incentive to the general partners, to have the deal perform very well because the more returns, and especially if you think about it if you can double your money into any investment, I think that would be and the typical hold is what four or five, six years. I think that's a pretty successful deal at that point. And now you're saying, well, look you double my money, I'm willing to give you more Mr. Sponsor, and I think it makes sense now as a sponsor. I'm very motivated to make that happen 100% hands down. And especially again, when you have the pref return that is in place, as we mentioned, all the cash flow is going to be directed to the investors and at that point it could be that a lot of deals these days that are making 8% cash on cash. So, it means there will be a good period of time when the sponsor may not receive a lot of money at all. So, I think the hurdle makes a lot of sense to provide an incentive for the sponsor to make the deal work very well and provide returns to the investors.

WS: Yeah, for sure. No, I couldn't agree more. Yeah, it does incentivize them to perform right? And to make that deal work as efficient as possible. What about other questions that you might encourage an investor to ask before investing in syndication? Anything else that you would think through, think about? Or even as you've learned a lot more about the syndication business now, you probably have a lot better questions to ask that sponsor before you invest.

PS: Actually, and I think, what comes to mind is a question that as a sponsor, I asked the investors. And it's amazing in some cases, like, I remember talking to a couple one time a young couple young professionals, and I came to realize they were telling me, oh, we can, we could invest $50,000, but we need some time to bring the money together, etc. And throughout the discussion, I realized, that was pretty much young couple, young professionals, that was all their savings. And I told them, no, I don't think it's a good idea at this point to put all your savings into one deal even though it's real estate. The risks are lower but who knows what can happen? If you're a black swan event like COVID, it could be something else in the future, who knows, but you don't want to have all your money tied up in one deal. And that's where you have to invest in a smart manner, and you don't want to invest like all your eggs in the same basket. So, that's one thing that investors should consider.

PS: And I think it's okay, in that case, to ask the sponsor and say, look I know the minimum investment is, for instance, $75,000. But really, I'm comfortable with investing $25,000. Is it okay for me to invest a lower amount? And I think once the sponsor understands the circumstances, they will probably let you in Again, if they're not all in for the money, that they should, in my opinion. Another question that they should, that an investor should look at is, I think it's really going back to the sponsor what was their experience, how many deals they have done in that market. In my experience working with different groups, and that's how I grew my knowledge and my own experience, right?

PS: So, maybe you want the sponsor to have like a thousand units in a specific market. But if you take the concept of you don't want all your eggs in the same basket, at a higher level maybe you don't want to keep investing with the same sponsor over and over again, because they're going to be in the same market, and who knows something can happen in that particular market. So it becomes interesting to go and work with different sponsors, which are in different markets, or with groups who are working as co-sponsors, with these experienced sponsors in different markets. That's how you can diversify your investments in different markets throughout the nation and avoid any downturn or any critical thing happening in your portfolio in case something happens in that particular market.

WS: For sure, I think those are very wise words. Yeah, don't have all your eggs in one basket. Drop the basket, what happens? You don't get breakfast maybe for a few days. That's great. I just think every investor, especially when you're first starting, and even as you have invested in numerous deals, you need to think about that. There are many ways you can diversify, as you grow, and throughout different operators or different asset classes and all those things. What about what's your worst real estate failure?

PS: Oh, early on, so I mentioned, I did my first two deals. Then the third deal, actually, I happened to become a mentor on the deal I'm leading the deal to close. And our first deal, we became a little bit more ambitious, after I felt impressed on the larger deal. But there were several features on that deal that were kind of a little bit unique. It was, kind of, it was a new market for us, larger deal. We decided to work with an equity partner. And I think it was not wise for us to have this new business plan all together on this larger deal. And while we were led to believe that we had like several backups at the several layers, when we came close to the closing table, a few weeks away from closing, the equity partner bailed out on us. And we ended up having no real backup. And like several partners, obviously, including myself, we lost a significant amount of earnest money on the deal.

PS: But, I think it's part of learning; in that case, it was a very expensive learning experience. And I think that that's where you are now because I do mentor as well. I'm helping students to stay away from these more risky ventures, and try to steer them to something that is more mainstream, something that we have experience with. You don't want to be the first necessary to try a new business plan. And no, interestingly enough, other groups with whom I worked at that time, they experienced the same failure, interestingly enough. And it happens all the time, actually, where you're going to lose earnest money deposit. I mean, these days is because of financing. If you came into a deal with some business plan, and you expect the debt to be at this point, as we know interest rates are rising right now, we only know sometimes the deals, they don't make sense anymore. And the risk is, if the seller doesn't want to re-trade, you're going to lose your earnest money deposit. But see, this is a failure for the sponsor; it's not something that is going to be reflected to the investors because, at that point, investors didn't engage any money.

WS: Yeah, now that's a great point as well, a risk that operators are taking with typically their own capital or it may be a partner too in the beginning when you're first getting started, but thankfully, it doesn't affect the capital most times of the LP or passive investor. Philippe, again, grateful for your time today and just thinking through, what are the responsibilities of the syndicator even responsibilities for the investor as they are looking at a project even diving into some of the structure components of a syndication because that can oftentimes seem so complicated, until it's just explained. I feel like it's not as complicated as often we think it may be when we first hear about this big scary word of syndication, right? And so just grateful for your explanation and just walking us through those things. Again, tell the listeners Philippe, how they can get in touch with you and learn more about you. And we're gonna dive into another topic tomorrow. about the syndication business and how sponsors make money. We're also going to talk about a fund that Philippe has and how it is structured.

PS: Thank you, Whitney. So, your listeners can reach out to me via my email address. So, it's my first name philippe@boostmycapital.com. Or check our website, BoostMyCapital.com. We have a little document there they can download regarding different ways to invest your retirement money. That could be interesting for your listeners.

[END OF INTERVIEW]

[OUTRO]

Whitney Sewell: Thank you for being with us again today, I hope that you have learned a lot from the show. Don't forget to like and subscribe. I hope you're telling your friends about the Real Estate Syndication Show and how they can also build wealth in real estate. You can also go to LifeBridgeCapital.com and start investing today.

[END]