**EPISODE 1514**

[INTRODUCTION]

**Rob Beardsley (RB):** In my opinion, debt is your number one source of risk in a real estate deal. And I would guess something around 98% of real estate deals include that in one shape or another. So, it is in your best interest to be well-versed in the nuances of it and why it is the riskiest part of the deal, and what are the attributors to that risk.

**WS:** This is your daily Real Estate Syndication Show. I'm your host, Whitney Sewell. Well, we are back with our guest, Rob Beardsley. He goes into deal structuring. Right? We're gonna go much more in-depth today about the importance of the deal structure. And what does that mean? The debt to equity? What are those things? And what are the different ways to look at those things as we look at structuring a deal to make it make sense? Or how much risk is too much risk? You know, when we're talking about the debt or the equity, how should investors look at that? You're going to hear that today.

Again, I hope that you have liked and subscribe to the show. I hope you're sharing it with your friends, as you are also learning from the show.

[INTERVIEW]

**WS:** Rob, welcome back. I'm honored to just continue a series of shows here with you and be able to dive in a little deeper on a topic which I feel I know you feel is very important in this business.

**RB:** Yeah, looking forward to it.

**WS:** Well, let's do that, you know, deal structure. You know, actually, I remind the listeners though, before we do that, go back and listen to yesterday's show, we did dive into his new book, and where you can get that, why you need to read it, and almost it doesn't matter where you're at in this business, you're gonna learn something from that book, and hopefully some ideas that are going to help you as you are purchasing, you know, large assets. And these things matter. It makes a big difference. I know Rob alluded to that some but some of these little things that whether it's on the underwriting restructuring piece or debt, it makes a big difference, especially later on down in your in your project.

Let's dive in Rob, deal structuring. If we're talking about deal structure, I know we briefly mentioned it on the last segment. But let's elaborate a little deeper on what does that mean? And why should the listener care.

**RB:** We're specifically talking about capital structure, and your capital structure is usually made up of debt and equity. And those are the broad categories. But inside both of those categories, there's a lot of nuance and a lot of different structures and products. So that's your entire capital stack. And we will certainly dive in and go deeper on all though all those fronts. And then as far as why it's important, you know, I mentioned this on the last one, I'll mention it again, in my opinion, debt is your number one source of risk in a real estate deal. And I would

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guess something around 98% of real estate deals include that in one shape or another. So it is in your best interest to be well versed in the nuances of it and why it is the riskiest part of the deal, and what are attributed to that risk.

And then on the equity side, as a passive investor, you want to make sure that you're investing in an equitable deal structure. And on the sponsor side, you want to make sure that your deal structure is actually attracting investors rather than scaring them off. So it's important to make sure that there's a nice balance in the middle there.

**WS:** Yeah, that's awesome. Debt and equity. Well, since that is the riskiest source, help us to think through that. Why is it the riskiest you mentioned do knowing what contributes to that will help us to think through that?

And I'd love obviously, for the passive investors that are listening to to be educated enough about this to know what questions to ask Rob or myself or whoever the operator is, you know, as they're contemplating, you know, which has the least amount of risk, you know, that they're about to invest in? What kind of deal so what should they know what contributes to that? Why is it the riskiest part?

**RB:** Yeah, so the number one concern or at least our number one concern when investing is the preservation of capital. Now, what does that really mean? Well, that means we want to avoid permanent loss of capital, it's okay, if we have a temporary decline in value of the property, that's okay. It's okay for the property to go down in value, because we don't necessarily have to sell at that point in time when it goes down in value. But, what we must avoid is being forced to sell when we don't want to in a down market. And that is often debt related.

And then number two, even worse, we don't want to be foreclosed on by the lender and lose the asset completely. So those are the number one concerns and things to avoid. Now, you could just say, well, to avoid that, you just don't take any debt. Right? And that is not very realistic for most deals. And the reason for that is that if you're trying to buy a $20 million deal, that's $20 million of equity if you don't use any debt, that's not very realistic.

But even more importantly, the returns don't look very attractive. Real estate is a business built on debt, and unleveraged returns, which means no debt involved is not an attractive return profile for investors to invest in, so they just won't invest. So there's this balance that needs to be played of using debt to enhance the returns, but not going too far to create undue risk.

And we touched on it in the last segment, but we'll dive in now as far as the key metrics, which are leverage, interest rate, and term. So starting with leverage, that's probably the most important one. If you have higher leverage, then your returns on paper go up. But your risk in reality goes up as well. The less leverage you use, then more your returns don't look as great but you're setting yourself up for more success and less of a bumpy ride when you're actually going through the deal.

So finding that sweet spot is really important. And there are a few ways that we approach that with metrics such as loan-to-value, loan-to-cost, and debt-service coverage ratio. And then we

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also do some stress tests and sensitivity analyses. So that's more of an underwriting conversation, you know. Going back to my first book, about getting into the drilling into the numbers and figuring it out, but the high-level concept that we're talking about today is just leverage and the structure of it. Do you want to have high leverage, low leverage, short-term debt, long-term debt and things like that.

**WS:** Maybe give us some of the questions that you ask yourself when you're considering what type of debt? You know, and I would say at a high level, you know, just think through the different types of debt? Maybe you can list a couple of different types and within a list get even more specific to today's market? What kind of debt are you looking at?

But first, you know, kind of high level? What kind of debt are you thinking, you know, when you're first looking at a deal, just everything was available? And the questions you would ask yourself to figure out which one, maybe I should go with.

**RB:** So high level for us, for in our multifamily space, we're looking at agency debt, which is Fannie Mae and Freddie Mac, government-backed debt, bank debt, and bridge debt. And inside of those groups, there are some nuances. You know, there are different types of bridge lenders, some bridge lenders loan off of their balance sheet, some bridge lenders securitize the loans through a CRE or CLO.

So there are different types of nonbank lenders and executions there. But those are kind of the general groups that we look at. And I would say, at a starting point, we're looking at does the deal work for agency debt. And the reason why we want to look at that first is that agency is very favorable and has a great balance of risk and reward, I would even say the risk is quite low with agency loans.

However, the problem is, agency loans are very strict in their underwriting metrics. And if you don't have enough in place income on the property, then you're going to struggle putting enough leverage to make the deal make sense, you know, at some point, you're gonna say, "Well, if the agencies are only willing to give me 40% leverage, that's probably not a deal that's going to work for us."

So that's where we start because we know that the other lenders such as banks, and bridge lenders are more flexible. So I like to start with the least flexible doesn't work for the least flexible and then work our way out. However, this topic is almost exacerbated in our current market, because we have a situation where interest rates have risen rapidly as we've kind of had an interest rate regime change with inflation driving the Fed to raise rates, so the market is a little bit dislocated right now.

So that problem with agencies being able to put leverage on the deal is even worse, you know, and that's why I said 40% because 40%, honestly fairly realistic in today's market as max out leverage for the agencies, which for most people, that's 40%. Leverage is a nonstarter, so they have to go somewhere else. And this is the fascinating problem with our current debt environment because normally, that would push a borrower into the hands of a bridge lender. But if you look at bridge loans today, they're extremely expensive, they're so expensive, that your interest rate now is well above your unleveraged yield on the deal.

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And when you have a situation where your unleveraged yield, let's say is six, six and a half even 7%, but your cost of debt is 8%, even 9%. You know, your deal is upside down, and the numbers don't make sense. So we have a very odd market where the deals don't quite pencil for leverage on agency, but then the interest rates too high on bridge.

So it's a very challenging environment. And one bright spot has been banking. Banks have stepped up and provided great capital in the middle cheaper than the bridge a little more expensive than an agency, certainly a lot more flexible with term prepayment penalties, as well as their ability to provide leverage, not as high as bridge lenders, but it's a sweet spot. So we've done a bunch of bank loans this year, after kind of all the interest rate changes have occurred, but it's unfortunately not that easy, because with all the demand for banks, they've pulled back as well, because they're not used to putting out this much money and being in such high demand. So they're pretty much running out of steam at this point. So where do we turn next for debt? It's a tricky market.

**WS:** So you mentioned you know, agency debt gonna turn into banks bridge loans, also what about, you briefly mentioned what about recourse so, you know, obviously agencies typically nonrecourse but if you go to banks, are you okay with recourse? How do you feel about that as we think about debt?

**RB:** Generally speaking, we are not okay with recourse. And I think we're in line with much of the market, which is to avoid recourse as much as possible. And we've had some interesting situations this year where lenders have, I don't want to say anything negative, but have essentially retreated us. And that's a bad word in our business. And retraining means basically changing terms on somebody without real good reason.

At the last minute, it's a different thing where if you're a buyer, and you do your homework, and you find something wrong with the property and you say, "Hey, I need a $2 million discount on the price because I found these things, right?" That's not really a retrade because it was out of the buyers control, but if the lender just simply goes, "You know what I'm getting kind nervous about this economy, I'm just going to ask you to provide a recourse guarantee." That's a bit of a retreat.

So we actually did have that happen to us, and not really any other choice. You know, when you are at the last minute with the deal, you're deep in escrow and the seller is expecting you to close, you need to make that move happen. So, unfortunately, we did, and we made the necessary things happen in order to amend the loan and provide a partial recourse guarantee. So that's not something that we are happy with. But in these times, you know, there are certain measures like considering recourse in order to get better deals done.

**WS:** And they know they got you at that point, you're gonna do it. Right? I mean, hopefully, you believe in the deal.

**RB:** Oh yeah, absolutely. And also you bring up a good point, right? They kind of have you in a position where you have to do it. But what does that say about the long-term relationship?

**WS:** Yeah, that's exactly right. I don't feel like they're thinking long-term.

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**RB:** No.

**WS:** No doubt about it. Well, what about some other types of deal structures that maybe we haven't talked about, as we think through the debt and equity, maybe you can talk about the, you know, the equity coming into play as well?

**RB:** Well, something that's getting a lot more interesting these days is preferred equity or any type of gap financing, because agencies are where they are, you know, they're anywhere from 40 to 60%. Leverage, and many borrowers are still desirous of taking they're all in leverage to somewhere around 70 to 80. So there's a gap there. And that gap can be fulfilled by mezzanine debt, it can be fulfilled by preferred equity.

And also, another just kind of wrinkle of preferred equity is something called participating preferred equity, which is a hybrid of regular equity that participates in the upside, but it also has some preferential treatment, like preferred equity. So there's, you know, a little bit of structure for everybody. And I do cover more details on what those look like in my book, but high level, the reason why it's getting interesting is, firstly, you have this problem of, let's say, the agency lender coming in at 50% leverage when you're desirous of being at 70. So that 20% gap can be filled by the pref equity provider.

Another reason why it's more interesting today is because general interest costs are higher. So rewind a year ago, when rates were really really cheap. A prep lender offering you a preferred equity loan at 13% wasn't that exciting because look around you debt was so much cheaper everywhere, you might as well just borrow the bridge loan, which would give you 80% leverage at three and a half percent, you know, rather than taking that incremental leverage at 13. But now in today's environment, 13% actually from a preferred equity provider is doesn't look that bad anymore, you can blend the rates, which that's a concept of taking multiple portions of your capital structure, such as your senior loan and your preferred equity. And you take the interest rates of both and you blend them together.

So you see, what does that total cost of capital equal for both of those things together? If you take, you know, the agency plus the pref, the blended cost of capital today can be somewhere, you know, in the low to mid sixes, which is that different than a bank loan today, and it's cheaper than a bridge loan. So that is a really interesting flip that has occurred in the market where a senior plus pref combo is now potentially better than a bridge whole loan essentially.

**WS:** Would you just set it at a high level too, so that, you know I know all the listeners understand you and I talked about preferred equity gap financing, mez debt, even the participating partner, you're just at a high level, when would we see those come into play? Or maybe what that is at a high level as well?

**RB:** Yeah, what they are at a high level, mezzanine debt and preferred equity really are the same economic concepts. They're just structured differently from a legal standpoint. So mezzanine debt is financing provided outside of the org chart or outside of the operating agreement of the deal. Whereas preferred equity is technically not structured as a loan. It's structured as an owner in the LLC with preferential rights.

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So instead of a maturity date, with a mezzanine loan, where they actually have collateral that they can foreclose on, if you actually are inside of the the org chart with your preferred equity position, you have a redemption date, and you have, you know, maybe the right to remove the manager and certain major decision rights inside of the operating agreement.

But functionally, they are equivalent, in that they are providing subordinate debt to the senior loan at a higher interest rate. And there's some flexibility also, the interest doesn't have to be paid a solely monthly portion of it can accrue, and that provides the borrower flexibility where if they can't make the full 13% payment every single month, maybe they can make 8% payments every single month and then the remaining 5% can accrue every single month until the borrower is ready to finally pay off that equity and you know, a year or three with a new loan or a sale.

**WS:** Okay, now that's helpful. I just try to bring us all on the same level as much as we can as we are talking about different things. What about just summing up preferred structures that you kind of stick to or move towards? Or are there, you know? Or is it completely based on what's available, the market, or the deal? How, you know, the kind of tends to go towards some specific ways?

**RB:** Yeah, we have our preferences. But this is one thing that I love so much about our business is that it's so dynamic. Today, we find ourselves in this market, which has a very difficult and complicated, I don't want to say complicated, but it's just a very difficult time to obtain financing, right? But less than a year ago, it was wild, and every lender was, you know, fighting to give you a loan at the best rates and everything.

So we're always in a different environment, which causes you to need to strategically evaluate the situation and pivot if necessary, but for us, we are and we're evolving, and we're learning different things as we go through these experiences. But what we like to do is try to keep things as simple as possible.

So my preference is if the deal can work without preferred equity, and without different bells and whistles, than I would prefer, I prefer just to have a simple senior loan that is conservative at a fixed rate. And on the equity side, we try to keep things as consistent as possible, which I know we haven't spent time talking about equity. But our equity structure doesn't change deal by deal, we keep it very consistent with an 8% preferred return, and a 30% Promote up to a 15% IRR and a 5050 Thereafter, that's our base waterfall. And we don't make a habit of changing it.

We do, however, have a major investor share class, which has a higher preferred return of 9%. And no 50-50 split is involved in the structure. So we offer major investors investing half a million or more a better structure. And then beyond that, we may have larger investors or fund or fund managers that are coming in for a million dollars $5 million dollars, $10 million. And at that point, we will have a side letter agreement that will design potentially a whole new deal structure, kind of from scratch. So that still gives us the flexibility to have our base structure for the deal. And then be able to cater to our larger investors who kind of require preferential treatment.

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**WS:** Now that's incredible. Well, let's dive into the equity structure piece a little bit. What does that mean? You mentioned you all don't change it. And I wondered if that is like all the time. Or does it just stick to that? Or you know how you just deal by deal, you have to be able to have this return. Or you just don't do the deal? What does that look like and maybe dive a little higher into level two on what equity is? And then let's dive deeper.

**RB:** Yeah, you bring up an interesting point. So I know when you're looking at deals, and obviously, it's hard to find a good one. It's tempting to say, well, you know, what, what if we just make our deal structure a little bit discounted, and take a less a lower promote, so that our investors can get a higher return? Because these numbers are tight, right? It can be tempting to do that.

But in the end, I don't think it serves you because you're basically buying into deals that are thinner and tighter. And you're also selling yourself short and not giving yourself the full compensation that you believe you deserve. So I don't like the idea of trying to stretch the deal structure to make a deal work. So that's one reason to keep the numbers consistent.

So that way, we're no, we're looking at deals the same way across all the deals we're looking at, then we can really identify the best opportunities. Now the next piece is there's really kind of two styles of deals, there's syndication, which is, when you have many investors since there are many investors, the sponsor runs the show, because each individual investor doesn't have as much power, because they might be only investing 1% of the total deal.

So in that case, the sponsor has to establish a deal structure and say, "Well, here's the PPM, here's the operating agreement, and here's the deal structure." So there's not really a negotiation, not really a back and forth investor can essentially take it or leave it, maybe if they're big enough, they can approach the sponsor and ask about doing a side letter or having some sort of preferential treatment or different structure. Right? So that's one style of deal.

Now, the next style of a deal is a joint venture. And in a joint venture scenario, that's where you have a single investor who's very large, usually somewhere around 80 to 90% of the entire deal. And in those cases, it's not the sponsor that proposes the deal structure, it's actually the equity. So the equity says, okay, yeah, we like this deal. And here are the terms that we work with, and they drive the bus, they really are the determiners of the deal structure.

So it's interesting how you have two different scenarios and one the sponsor determines the structure and then one the equity determines the structure, but it's in the JV there is a negotiation, you know, you can absolutely negotiate equity structure at that point. But like I said, in the syndication, it would be somewhat odd to negotiate on deal structure, right? So Yeah, so we have experience in both deal types. And obviously when the equity is proposing the deal structure, then we can't keep our deal structure the same every time. Right?

Its starting point is there and then we negotiate from there, we try to get to an equitable middle that we feel comfortable with. So hopefully that is, you know, somewhat helpful as far as how we approach deals structure. It's not like we're rigid and saying, Well, no, we're only partners with you if you abide by our terms.

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WS: Yeah, no, that's incredible to think through joint ventures, I think joint ventures aren't thought about often when we're thinking about doing a $30, $50 million project, you know, but it's going to depend on that investor. Right? You know, you mentioned that investors are going to 80 to 90%, where's the other 10, or 20%? Gonna come from in that model?

**RB:** Yeah, great question. So I actually go into great detail in the book about this, because it's a little bit of a sore spot for me. So the funny thing is, with a traditional joint venture partner, you have, let's say, putting up 90% of the equity, and let's say it's a $10 million equity check. So they'll put up $9 million, and then you have to bring the rest, you have to bring a million dollars to the deal. And the way I break it down in the book is I say there are four different types of joint venture Equity Partners when it comes to this 10% equity requirement.

So the most strict is they want you to have that 10% come from your own pocket. So who the principals of the sponsor or the operator has to come from your pocket. And even in the most strict scenario, they want it to be net of the acquisition fee, so they actually dock the acquisition fee against counting towards your investment into the deal. And this, to me is a little bit bizarre, because I'm just not rich like that. I don't have millions of dollars to invest in every single deal. This is not the only deal I'm doing the entire year. So I feel like there's a little bit of a disconnect. When it comes to those really rigid requirements.

WS: I just want to make sure myself and the listeners understand here. So he said, you know, they're requiring this million dollars to come from you. If your acquisition fee was, say, half a million from the deal, just random. But let's say it's half a million, then they're gonna say, "Okay, you need $1.5."

**RB:** Yes.

**WS:** Yeah, yeah. So they're, they're not going to say you need a half a million, because you're gonna get a half million acquisition, they're gonna say, $1.5, to ensure it's all coming out of your pocket versus you're counting on the acquisition fee to make it happen.

**RB:** I mean, I totally understand where they're coming from skin in the game is really important. But I think it's a, it's just a little bit short-sighted, for them to expect that a sponsor is able to make that commitment for all the deals they're doing throughout the year and beyond. So that is the most rigid scenario, I don't see it all that often. But when I do see it, I honestly scratch my head, I don't think everybody is by those rules.

And to be honest, I really think that in those scenarios, someone is doing some line, there's some line going on, there's some something happening behind the scenes. Now, the next kind of less strict requirement would be when the equity partner says, okay, it can come from your pocket or from your close family and friends, right? They want to know that, well, if your grandma's investing, you're still very committed to the deal, right? It's maybe even more important than your own pocket. So that is more flexible and more understanding.

Now the next step would be them, not really caring, where it comes from, at all. And at that point, you basically have a mini syndication inside your joint venture, where you can take your million dollar obligation, and you can go out and do syndication and you can go to your private

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investors and you can raise, you know, $50,000 or $100,000 each, and go and get 10, 20 investors and pull them in into your million dollar co-invest. And now you've got yourself a nice joint venture. And so that is a really good way to do big deals, right, you can raise your piece, go get the big joint venture piece, and now you're buying $20, $30, $40, $50 million deals.

**WS:** Any thoughts on or actually, I wanted to mention a little bit about the, you know, the being required to bring the timber sale. You know, personally, I also would agree with what you said because it's, even investors sometimes I think can be in that piece expecting us to put in large chunks and every deal. I'm like, I want to invest in every deal. Even the lender, like I want to invest in the deal, but I can't put that much in every deal that we're doing.

You know, it's I agree it's a hard ask to expect that much to n plus, you know, I almost questioned the lender, even investors sometimes, like, well, you also want to make sure that I have the reserves personally like, right, I mean, to keep operating during hard times. That's just something that's important to me, it's like I want to be able to pay my team for, you know, 12, 18 months, pretty easy, even if there's no deals inside, you know.

And so anyway, I just I pressured them a little bit sometimes in that way. I'm like, wait a minute, you're putting me in a hard spot, you know, you know, by doing something like that, or we can, you know, we came for the earnest money on the next day or we will find other people to help if we have to, you know, but still, you know, it's like we were planning here for more than just this one project. You know, I appreciate that. You know, your thoughts on that as well.

Anything else, just even at a high level that we've been talking about before, we unfortunately in this segment, but I would tell the listeners to we're gonna jump more in the next segment to on even somehow it's changed recently for Rob or what he's looking at maybe now versus what he would have been six months ago or 12 months ago, and how he's adjusted, or maybe some challenges he's experiencing learn from, as far as he is underwriting so many deals and learn learning about the best ways to structure deals in our current economic climate.

But Rob, anything else as far as the debt, the equity, anything else that that, hey, you know, I really want the listeners to know this, it's important to take this away.

**RB:** Yeah, one piece that we'll just touch on is the actual raising part of the business, right? We talked a lot about structure, but a big really important piece is actually going out and raising it. And it's both for debt and equity. And it's important to have relationships on the debt side, to be able to go out and effectively raise the debt. And then on the equity side, you and a lot of other people in the space really spent a lot of time focusing and becoming experts in raising capital on the equity side.

And so that's a really broad topic. The focus of my book is not to reinvent the wheel as far as how to find investors and build relationships and things like that. But I do provide some unique insights on that front, both on the retail investor side, which you know, are essentially high net worth individuals that are not real estate professionals. And then also on the institutional side, I talk about how to find and interact and build relationships with these joint venture equity partners, which include family offices and private equity firms, that can really be a great way to scale your business.

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**WS:** Awesome. Rob, again, grateful for your time and being willing to spend this much time with us and dive into some of these topics. I feel also were very important, you know, as far as when you're looking at projects like this and taking so many investors in a deal so much capital, right? I mean, even if it was a duplex, I still want to know I've got to structure the best I possibly can, right? Even more so when we're talking about you know, $30, $50 million project or bigger.

So, thank you again, tell the listeners how they can get in touch with you learn more about you, and find the book.

**RB:** Absolutely. So you can grab a copy of the book at structuringandraising.com and if you want to learn more about myself and what we're doing at Lone Star Capital, you can go to our website lscre.com.

[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.

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