THE BLUEPRINT TO PASSIVE REAL ESTATE INVESTMENTS

SIMPLE OVERVIEW OF PASSIVELY INVESTING IN REAL ESTATE SYNDICATIONS

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next play INVESTMENTS

ABOUT THE AUTHOR

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Read Michael’s real estate blog **here**.

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SECTION 1

WHAT IS A PASSIVE REAL ESTATE INVESTMENT?

A passive real estate investment refers to an investment in real estate where the investor is not involved in the day-to-day operations of the property. In a passive real estate investment, the investor typically contributes funding towards the purchase, renovation, and/or development of a large property – such as an apartment complex or self-storage facility – that is managed by a real estate professional. In return, investors receive equity in the property and a share of the profits generated by the property.

Passive real estate investments can be an attractive option for investors who want exposure to the real estate market without the hassle of managing a property themselves. It can also provide diversification benefits to an investor's portfolio. As an added perk, investors typically have no liability.

Passive real estate investments are typically referred to as syndications or funds. These investments allow everyone to have a smaller piece of a bigger pie. In syndications and funds, investors pool their money together to purchase an asset. A sponsor, or general partner, puts the deal together by sourcing the deal, underwriting it, conducting thorough due diligence, arranging financing, bringing investors together to fund the deal, building a business plan, sometimes guaranteeing the loan. After closing, the sponsor is responsible for asset management, including managing the day-to-day operations.

SECTION 2

BENEFITS OF PASSIVELY INVESTING IN REAL ESTATE

Busy professionals should not be excluded from real estate investing. If you are a busy professional, or simply not interested in learning about the in and out of real estate, but still want to earn returns from real estate investing, passively investing could be the solution for you.

It is important to make your money work for you, rather than simply working for your money. If our capital is not working, it is literally becoming less valuable by the day, and our buying power is decreasing. With inflation at, let's say 6-8% - meaning at its core that most things we purchase are becoming 6-8% more expensive - and our "high-yield" savings accounts collecting a 1-3% return, it is becoming clear to many what is happening to our cash. Passively investing in real estate is a great hedge against inflation, and needed portfolio diversification.

Some of the benefits include:

- **Ownership**

Generally passive investors are owners of the property and are entitled to a percentage of any refinance or resale of the property.

- **Cash flow**

Passive investors are entitled to a portion of the cash flow, allowing them to put their money to work in real estate without exerting the effort required by a sponsor.

❖ Tax benefits

Passive investors should always consult their tax professionals, and while it depends on the structure of the deal, passive investors sometimes are entitled to tax benefits as the owner of the property. These tax benefits can include:

- Depreciation Deduction: The IRS allows real estate investors to depreciate the value of their investment property over time, even if the property is actually appreciating in value. This can result in significant tax savings for investors – as well as real cash flow from the property – as depreciation deductions can offset rental income and other sources of taxable income.
- Passive Activity Losses: If an investor incurs losses from a passive investment in a real estate syndication, they may be able to use those losses to offset other income, such as income from another real estate investment. This can help reduce the investor's overall tax liability.
- Capital Gains Tax Benefits: When an investor sells their interest in a real estate syndication, any gains realized on the investment may be taxed at the more favorable long-term capital gains tax rate, which is generally lower than the ordinary income tax rate.
- 1031 Exchange: Investors in real estate syndications may also be able to use a 1031 exchange to defer capital gains taxes on the sale of their interest in the syndication by exchanging the proceeds for a like-kind investment property. For example, an investor can defer taxes on the proceeds from a sale of a self-storage facility if that investor invests those proceeds into another similar investment.

Less Headaches and Risk

While a passive investor is an owner of the property, the passive investor is not usually responsible for bringing all the investors to the deal, nor are they responsible for managing the property. The sponsor will form the investor team, and will also form a team on the ground to ensure the property is inspected and retain a professional management company. The sponsor will also be responsible for handling all maintenance and managing contractors. Finally, if required, the sponsor will personally guarantee the loan on the property, meaning that passive investors will not be responsible for paying back the loan if something goes awry.

Forced Appreciation

Smaller residential properties are valued based on comparable properties in the market, while larger commercial properties are valued based on their net operating income. A sponsor can force appreciation by raising rents or reducing expenses, thereby forcing appreciation to the property.

Scaling Up as a Team

Some partnerships scale up together. For example, if a partnership owns a 20-unit apartment complex, the partnership may decide to sell the 20-unit, after experiencing appreciation, and purchase a 60-unit apartment complex. Passive investors are generally not obligated to scale, but have the option to do so. Scaling up increases the cash flow and equity for all involved.

Hedge Against Inflation
During inflationary times, rents and property values increase. This is logical because the more money an individual is earning, the more that individual will spend to purchase a property or rent an apartment or storage space. Investing in larger commercial deals gives a passive investor a solid hedge against inflation by investing, at a large scale, in real estate.

There are many other benefits to partnering with established real estate investors, and depending on your situation, it could be a win-win.

SECTION 3

HOW IS A SYNDICATION STRUCTURED?

One of the most common passive investment structures is a syndication. A syndication involves a group of investors pooling their capital to purchase a property. The syndicate is typically managed by a sponsor, also known as a manager, who is responsible for finding the property, negotiating the purchase, and managing the asset. The investors receive a share of the profits based on their contribution to the syndicate.

The sponsor is typically known as a General Partner, or GP, and the passive investors are referred to as a Limited Partner, or LP.

Here are some common offering terms that an investor may expect:

Equity
Limited Partners can expect to receive 70-80% of the equity in exchange for providing a majority of the capital necessary for a syndication. When equity distributions are made (the profits), Limited Partners will typically receive 70-80% of the equity distributions.

"The Pref" - Preferred return
In addition to being entitled to a pro rata share of the profits, Limited Partners are also entitled to a preferred return typically between 6-8%. Preferred returns are usually measured against a Limited Partner's investment. For example, if a Limited Partner invested

$100,000 and there was a 7% preferred return, the Limited Partner is entitled to receive an annual $7,000 preferred return.

This preferred return must be paid before the equity distributions are paid, meaning that a Limited Partner must receive a 6-8% return on investment before a General Partner is entitled to any equity distribution.

Distributions

Distributions can be scheduled monthly, quarterly (most common), or some other semi-regular scheduled time as agreed upon.

Liability

Limited Partners typically have no liability and are not responsible for the day-to-day management of the property. General Partners often own 100% of the liability and use their personal credit and issue personal guaranties, as necessary, to facilitate the property acquisition.

Fees

General Partners typically do a majority of, or all of, the required work in a syndication. This includes sourcing the deal, forming the syndication entity, putting the deal together by facilitating the Limited Partner investments and retaining a lawyer to handle the necessary SEC paperwork, conducting thorough due diligence, obtaining bank financing, managing renovations, implementing systems and processes at the property, and managing the property.

In addition to investing capital into a deal like a Limited Partner, General Partners also pay for the earnest money deposit – which is typically 1-2% of the purchase price – legal fees to form the syndication, and due diligence fees.

In exchange, General Partners generally are assigned 20-30% of the equity and collect fees. These fees often include an acquisition fee, asset management fee, and disposition fee. An acquisition fee is generally 1-2% of the purchase price, asset management is 1-2% of the gross income, and disposition is 1% of the eventual sale price when the syndication ends. These fees help to cover some acquisition, property management, and sale costs.

Paperwork

Because a syndication is a security, it is governed by the SEC. The SEC requires that Limited Partners sign syndication documents, such as a Private Placement Memorandum and Operating Agreement. These will be prepared by an SEC attorney retained by the General Partners.

Minimum Investments

Most syndications have a $50,000 minimum investment.

SECTION 4

HOW TO FUND A PASSIVE INVESTMENT

Investing in a real estate syndication offers investors an opportunity to own a piece of a large real estate project, with no obligation to manage the property and no personal liability. Finding funds to meet the minimum syndication investments, typically approximately $50,000 may be challenging. But, even if you do not have a large sum of money saved to invest in a real estate syndication, there are still many ways to finance your investment. Here are just a few:

IRAs

Perhaps the most powerful, yet least understood, strategy is using your IRA to invest in real estate. By simply converting your IRA into a self-directed IRA – which can be done easily by an IRA custodian company – you are now free to invest your IRA money into a real estate syndication. It is that simple! You are no longer at the mercy of the stock market, and can instead invest in real, tangible assets in real estate. At a minimum, folks should consider this to diversify their holdings. Here is any easy checklist to use your IRA for real estate:

- Choose a self-directed IRA custodian
    - This custodian allows you to direct your IRA investments to whatever you want - not limiting you to stocks and mutual funds.
- Fund your IRA
    - Once you have a self-directed IRA custodian, you'll need to fund your account. You can do this by: (a) transferring money from an existing

  - IRA or (b) rolling over funds from a prior employer's 401(k) - which you are free to use without penalty - or other retirement account.
- Identify a real estate syndication
  - With your self-directed IRA in place, you can start looking for real estate investments that meet your goals and risk tolerance. This can include investing in a real estate syndication or fund that is purchasing self-storage facilities or apartment complexes.
- Purchase the real estate investment
  - Once you've identified a suitable real estate investment, you simply need to complete paperwork and direct your custodian to transmit the funds.

Securities-Backed Lines of Credit

If you have a portfolio of stocks or mutual funds, look into a securities-backed line of credit. Your brokerage will loan you money and use your stocks and mutual funds as collateral. For example, if you have a $100,000 brokerage account, a brokerage house may loan you around $65,000, or 65% loan to value, depending on your holdings.

Home Equity Lines of Credit

If you do not have liquid money, lines of credit could help create it. Nowadays, many folks have equity in their primary residences, so consider a home equity line of credit. Oftentimes, the return you can obtain in a syndication far outweighs the cost, or interest rate, of the line of credit.

❖ **Personal/business unsecured loans**
Unsecured loans are more difficult to qualify for, but some banks have programs for them. Check out whether your bank has a program or shop around.

SECTION 5

HOW TO FIND A PASSIVE REAL ESTATE INVESTMENT OPPORTUNITY

Investing capital into a real estate syndication presents an exciting opportunity for many investors. Particularly if that capital was otherwise sitting in a savings account, IRA, or the stock market. An investor can own a piece of a large property, without any obligation to manage the day-to-day, and reap the benefits of cash-flowing real estate.

That raises the question: how do you find a real estate syndication? You can't find them on Zillow or Redfin. Here are some ways to identify syndication opportunities:

- **Your circle**

  Most investors want to invest with people that they know, like, and trust. If folks in your circle syndicate, start there.

- **Network with other real estate investors**

  Join real estate investment groups, attend real estate investment events, seminars, and conferences to meet other investors and build your network. Ask for referrals to real estate syndications and gather information about their experiences.

- **Search online**

  Use search engines to find real estate syndication websites or online platforms that connect investors with real estate opportunities. Some popular platforms include CrowdStreet, RealtyMogul, and EquityMultiple.

❖ **Consult with a financial advisor**
A financial advisor may have folks in his/her network that syndicate real estate, and can also provide guidance on real estate syndications and help you evaluate the risks and rewards.

It's important to thoroughly research any real estate syndication opportunity and understand the terms and conditions before investing your money. This includes reviewing the investment proposal and verifying the track record and experience of the sponsor or syndicator.

SECTION 6

PASSIVE INVESTOR BENCHMARKS FOR SYNDICATION RETURN ON INVESTMENT

As an investor is comparing investment opportunities, they should be careful to compare apples-to-apples. A stock market's 6% average return is not equal to a real estate syndication's 8% cash-on-cash return that investors place in their pockets quarterly (see example below).

The syndication return is actually much greater than 6% or even 8% because the cash-on-cash return does not account for appreciation, depreciation, tax benefits, and return of capital events like refinances or sales. In reality the 6% stock market return must be compared to the internal rate of return for real estate syndications, usually around 15%.

Most syndications have three phases: (1) the value-add years; (2) the refinance; and (3) the sale. There are some common return on investment benchmarks that Limited Partners may expect in each of the phases.

1. The Value-Add Years

During the value-add years - typically the first 1-3 years – the General Partners will focus on stabilizing the property and increasing its value by increasing the income and optimizing the operations. Limited Partners can generally expect a 6-8% cash-on-cash return during this phase. For example, if a Limited Partner invested $100,000, it would be common to receive $6,000-$8,000 annually, distributed in quarterly installments.

2. The Refinance
Most real estate syndications include a projected refinance. A refinance generally occurs when General Partners have increased the value of a property and thus have excess equity that they can return to Limited Partners. Take this illustrative example:

Purchase and value-add
- Property purchased: $650,000 (in cash)
  - For illustration purposes, a bank, if used, would be willing to finance about 75% of this value, or ~$487,000
- Repairs and expenses required to optimize operations: $100,000
- Total Capital Required: $750,000
- New property value following the value-add: $1,000,000

Refinance
- Because the property value increased to $1,000,000, the syndication will refinance
- The bank will now be willing to finance 75% of $1,000,000, resulting in the bank giving the syndication a $750,000 mortgage
- The bank will transfer the syndication $750,000 (subject to any other mortgages)
- As you may recall, the total capital required to purchase and add value to the property was $750,000
- The $750,000 payment from the bank pays the syndication every dollar required for the initial purchase and repairs/optimization

In the above example, the General Partners added significant value to the property. Thus, they are able to return every dollar that a Limited Partner (and General Partner) invested. For example, if a Limited Partner invested $100,000 at the outset of the syndication, the $100,000 was returned to the Limited Partner as a result of the refinance.

Even better, the Limited Partner still retains his/her share of ownership and equity, and is never diluted. As cash flow continues post-refinance, the Limited Partner continues receiving quarterly distributions.

If a Limited Partner's initial investment, $100,000, was fully returned as a result of the refinance, his/her return on investment is infinite. In other words, the Limited Partner has, in actuality, invested $0 because the initial investment was fully returned. So, the Limited Partner is now making thousands of dollars per year on the $0 investment.

3. The Sale
Syndications generally have a 3-10 year hold time. After a syndication has generated cash flow, appreciated significantly, and utilized all of the tax benefits associated with real estate, it is prudent to sell the property. General Partners and Limited Partners usually use those profits to purchase another bigger property, and start the process again!

Limited Partners cannot generally expect to measure their performance by various metrics, including Internal Rate of Return, known as IRR, and Equity Multiple. In short, these metrics account for the cash flow, appreciated, depreciation, tax benefits, and return of capital events like refinances and sales.

A typical IRR can be between 14-18%. A typical Equity Multiple can be between 1.5-2.5, meaning Limited Partners can expect their capital to grow by 1.5x, and could even double or 2.5x, during the syndication.

The following page contains a sample breakdown from a real deal.

Sample $100,000 Investment - Years 1-5

Remaining Investor Capital	$100,000	$100,000	$100,000	$35,023	$35,023
	Year 1	Year 2	Year 3	Year 4	Year 5
Annual Cash Flow	$6,803	$8,095	$8,465	$4,401	$4,794
Return of Equity From Refinance	-	-	$64,977 Projected refinance	-	-
Total Annual Distributions	$6,803	$8,095	$73,443	$4,401	$4,794
Annual Distribution ROI	*6.83%*	*8.09%*	*73.44%*	*12.57%*	*13.69%*

Sample $100,000 Investment - Years 6-10

Remaining Investor Capital	$35,023	$35,023	$35,023	$35,023	$35,023
	Year 6	Year 7	Year 8	Year 9	Year 10
Annual Cash Flow	$5,200	$5,617	$6,047	$6,489	$6,945
Return of Equity From Sale	-	-	-	-	$35,023
Profits From Sale	-	-	-	-	$65,257 Projected sale
Total Annual Distributions	$5,200	$5,617	$6,047	$6,489	$107,225
Annual Distribution ROI	*14.85%*	*16.04%*	*17.26%*	*18.53%*	*306.16%*

Sample $100,000 Investment - Return on Investment

10-Year Internal Rate of Return (IRR)	15.01%	Investment	$100,000
Avg. Annual Cash-On-Cash Return (Cash Flow)	12.94%	Ending capital	$228,269
Equity Multiple	2.28	Total gain	$128,269

SECTION 7

HOW TO EVALUATE A REAL ESTATE SYNDICATION

Not every joint venture or syndication is created equal, and investors should do some due diligence on, not only the deal, but the sponsor.

It will be obvious to many investors to consider the return on investment. A sponsor should be able to provide you with a clear business plan illustrating a pro forma return on investment and cash on cash return. Aside from that, here are some less obvious things to consider when evaluating a joint venture or syndication opportunity:

The Sponsor

Perhaps the most important piece of due diligence by an investor is due diligence on the sponsor. The sponsor is the individual personally responsible for the deal, and is the individual that will be managing the day-to-day. A passive investor should trust a sponsor because the sponsor will be responsible for the investor’s capital.

Timeline and Exit Strategy

Every project has a different timeline. Some are 1-year holds while other deals are 10-12 year olds, with everything in between. Understand your goals, when you may need access to the capital you plan to invest, and invest accordingly.

The Business Plan

Ask questions about the sponsor’s business plan and understand the strategy. Is the plan to add value to the property and then refinance? Is the plan to organically increase rents and then sell in 5-7 years? Will the sponsor be utilizing professional property management that has executed this business plan previously?

- **Fees**

Many sponsors will charge passive investors high fees in exchange for acquiring the deal, and additional fees for managing the asset. Be sure to understand whether fees are being charged, and the amount of those fees.

While investing in a joint venture or syndication can be passive, an investor should consider doing some due diligence at the outset to ensure it is the right opportunity at the right time. Understanding the foregoing, and all the variables that come with the deal, will help ensure a smooth relationship between all involved.

SECTION 8

REASONS TO INVEST IN REAL ESTATE DURING A RECESSION

The unfortunate reality is that recessions are part of the economic cycle, and nearly impossible to avoid. Historically, real estate values have continued to increase the past few decades - sometimes even during a recession - despite several recessions. Here are some reasons why real estate is a relatively safe investment, even during recessionary times:

❖ **Cash flow**

Even during a recession, an investment property should be producing monthly cash flow. This cash flow is generally a hedge against a recession, and inflation, because as more money is printed, rental rates increase. While many other investments, like stocks for example, fluctuate in value, they do not produce monthly tangible cash to put in your pockets. Conversely, real estate investors are still collecting monthly rent during a recession, and in most cases, locked in with long term fixed rate bank financing.

❖ **Less Sensitive to Volatility**

Real estate values, particularly commercial real estate values, are less sensitive to economic volatility than the stock market or other investments. Real estate is often referred to as a "get rich slow" investment, so short-term economic instability will have less impact on real estate.

In fact, certain real estate classes, like self-storage and multifamily, outperformed during the Great Recession.

From 2008 to 2012, the major publicly traded self-storage companies - CubeSmart, Public Storage, Extra Space Storage, and Life Storage - saw a brief share price decline in 2008 before soaring the following three years. Not only did commercial real estate assets like self-storage outperform the market during the Great Recession, they increased in value dramatically.

Tax benefits

Tax benefits are not eliminated during a recession. As many know, real estate investors have tremendous tax advantages. Some of the many benefits include depreciation and reducing tax burdens.

Forced Appreciation

Because real estate is a “get rich slow” play, investors should look at the appreciation they will achieve during the life of a project. While smaller residential properties are valued based on comparable properties in the market, larger commercial properties are valued based on their net operating income. An investor can force appreciation, even during a recession or inflationary period, by raising rents or reducing expenses.

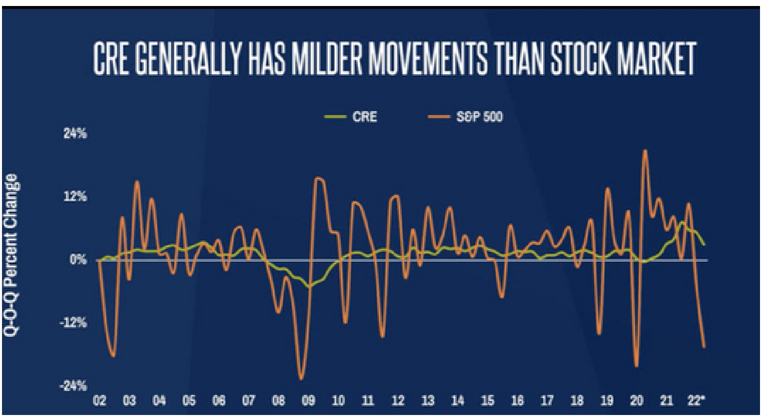
Planning for a recession is paramount. Diversifying with real estate investments can help balance your portfolio. Syndicators may even find some properties “on sale” as a result of mismanagement leading up to a recession, leaving even more meat on the bone for investors.

SECTION 9

COMMERCIAL REAL ESTATE VS. THE STOCK MARKET

Stock market volatility has left many questioning whether trusting their capital in the stock market is the right decision. Combined with increased volatility, the stock market offers investors minimal monthly cash flow and minimal, if any, tax advantages. Though the stock market is considered the logical and easy thing to do, there are additional avenues to gain return on your capital.

Commercial real estate has been more stable than the stock market during the past few years, and has consistently produced higher returns.



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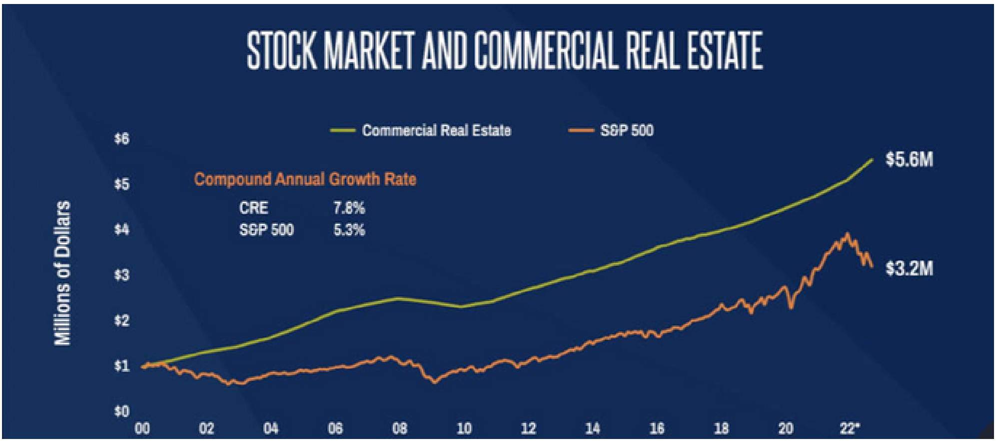

Source: Marcus & Millichap

Even passive real estate investors can take advantage of the benefits of being a commercial real estate owner.

SECTION 10

RISKS OF NOT INVESTING IN REAL ESTATE

Not investing in real estate is a conscious decision. You are betting that your alternative decision will produce gains that exceed the gains you would realize if you chose to invest in real estate. Sitting on the real estate sidelines has similar risks as consciously choosing to invest in real estate.

Stop me if you've heard any of these phrases before: "real estate investing is too risky," "we're due for a real estate crash," "what if a tenant doesn't pay rent?" Real estate investing, like most other things in life, absolutely comes with risk. But, what if we turned some of these phrases and questions around: "can you afford *not* to invest in real estate?"

By not investing in real estate, you may be choosing to place money in a savings account. By not investing in real estate, you may be choosing to invest money in the stock market. These are choices that have risks, and impact your net worth.

When making the choice of investing in real estate or otherwise, do so consciously and analyze potential results of each choice. You may be able to mitigate your risk by pairing real estate investing with other parts of your life and portfolio.

Disclaimer: Individual circumstances may vary and readers are encouraged to seek advice from their financial professionals and planners, and attorneys.

BONUS

10 QUESTIONS TO ASK A REAL ESTATE SYNDICATOR BEFORE INVESTING

1. How long have you been in the real estate syndication business, and what is your track record?
2. What is your investment strategy and philosophy, and how do you select the properties you syndicate?
3. What is your target return for your investors, and how do you plan to achieve it?
4. What is your fee structure, and how do you ensure alignment of interests with your investors?
5. How do you communicate with your investors, and what kind of reporting can they expect?
6. What are the risks associated with this investment, and how do you mitigate them?
7. Can you provide examples of successful syndications you have completed in the past?
8. What are your goals with this syndication?
9. How do you handle investor exits or liquidity events, such as refinancing or selling the property?
10. What is your investment horizon for this syndication, and what are your plans for the property after that?