# The Ultimate Guide

## To Buying Apartment Buildings

## With Private Money

By Michael Blank

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# Introduction

## Course Overview

Buying apartment buildings gives you a unique mix of high return, low risk and passive income which make it the best long-term investment in the world.

This course covers everything you'll need to buy your first apartment building with a focus on raising money from private individuals. But beware! This eBook is very hands-on and action-oriented. It uses real-life examples and case studies to give you the knowledge and confidence to take immediate action and get results. Here's what you will learn.

**How To Raise Money from Private Individuals**: The secret to raising money is to prepare a fictitious Deal Package that you can present to your potential investors and get financial commitments from them - long before you have your first property under contract. This secret allows you to get started with buying your first apartment now (whether or not you have money or credit), allows you to make offers confidently, and lets you close on time.

This chapter shows you to create your Deal Package, how to find your potential investors, and what to do and say when you get a meeting with one. I spend quite a bit of time describing the different ways you can structure the investment, from a Single Member LLC to an LLC with different membership classes that will do what you want it to do. I describe in detail the operating agreement, private placement memorandum, and subscription agreement that you'll need to set up the LLC properly and be compliant with securities laws.

**Select the Right Area in which to Invest (Even Out of Area)**: The trick is to look for properties in the right kind of area. And within that area, you want a property to which you can add significant value in a short amount of time. But how do you recognize the "right" area and property? If you can't find good deals in your own back yard, how do you go about building a team outside your area?

**How to Find Deals**: The # 1 way to get deals is from experienced commercial real estate brokers who take you seriously. This chapter contains sample emails, scripts and other tips to help you build trust with these professionals. This chapter also covers other techniques to acquire deals, including sending letters to apartment owners, my second favorite method for finding deals.

**How to Build an A-Team**: Long before you put your first property under contract, you need to have a team of professionals around you, such as a property manager, attorneys, lenders, and inspectors. This section describes in detail how you interview, qualify and get instant credibility with these professionals (which is tough to do when you're first starting out!)

**How to Analyze the Deal**: When a deal comes in, you will need to answer the following questions as quickly as possible: What is the building worth? What are your investment criteria and objectives? How would you structure the deal with the investors? What are the returns for you and your investors? How will you be paid? How believable are the reported financials? What is your version of the truth? What is the most you could pay for the property? This section shows you how to answer all of these questions so that you can determine an acceptable offer price. This section also covers the different kind of ways

to structure the deal, how to calculate your investors' returns, and the different ways to compensate yourself.

**Make and Negotiate Offers**: Making and negotiating offers is all about the numbers. You need to know when to walk away, so your upfront analysis is critical. This section contains negotiating tips to help get your offers accepted, whether you're negotiating in person or through a broker. It covers in detail the Letter of Intent and the critical terms of the Purchase Agreement that will get you out of the deal if you don't like it.

**Perform Due Diligence**: You have a deal under contract - congratulations! Now the real works begins. This section will show you how to analyze the financials you received from the broker or seller, how to inspect the property, how to uncover any new information that could materially alter the deal negatively, and how to update your projected financials as you get new information to see if the deal still works or if you need to re-negotiate or get out of it.

**The Closing Process**: This section describes the steps from completion of due diligence to closing, including: finalizing your loan, creating the proper entity and drafting the appropriate legal documents, managing your investors, and a break-down of expected closing costs.

**Finance the Deal**: I cover several creative financing strategies such as seller financing, taking the property subject-to its existing mortgage, assuming the mortgage, and master leasing the property. These techniques are valuable to know about and can be used once in a while. However, by far the # 1 way to finance apartment buildings is still with a traditional commercial loan. I spend a LOT of time in this chapter describing in detail how to work with multiple lenders and select the best one, how to create a Loan Package that will get accepted, and how to overcome personal financials that may not support the deal.

**Manage the Property for Maximum Profits**. This chapter describes different techniques to increase income and minimize expenses, how to manage your property manager, and considerations for accepting subsidized housing tenants.

**Exit Strategies**. In this chapter, I cover different exit strategies, such as flipping the property, re-financing, and selling outright (and tips for working with brokers and preparing your property for sale). I also describe the 1031 tax deferred exchange.

**Let's get started!**

## Why Investing Apartment Buildings is the Best Way to Achieve your Financial Goals and may be the Single Best Way to Retire Early

Investing in apartment buildings is one of the best investments you can make with your money - better than the stock market or even single family rental property. Just a warning though: apartment building investing is not a get-rich-quickly scheme. But it <u>is</u> the best way to build long-term wealth. Here's why.

### Reason # 1: Apartments give you three ways to make money

What I like about apartments is that you have three ways to make money

- **Cash flow**: apartments typically produce steady cash flow.
- **Amortization**: your tenants are paying down your mortgage for you - isn't that great? This can really add up after several years.
- **Appreciation**: as you increase rents and control costs, your operating income will increase, and with it, the value of the property when you sell.

When you combine cash flow, amortization, and appreciation, the total return of an average apartment building investment is impressive, especially after 5-10 years or longer.

Combine this with reasons # 2 - # 5, and apartment buildings are hard to beat as an investment.

### Reason # 2: Apartments are easy to finance

Real estate is the easiest business for which to get financing for compared to any other business. Banks like the security of real estate. People understand and trust real estate, so it is easier to raise money for real estate than any other business. Apartments are even easier to finance because they're less risky than a single family rental property. This is because multiple units spread out the risk of unpaid rent (this is one argument for investing in as many units as you're comfortable).

### Reason # 3: You control the value of an apartment building

Unlike the value of a house, which is dependent on the selling price of similar houses in the same area, the value of commercial real estate depends on the income that property produces. The higher the income, the higher the value.

This means you aren't dependent on the market, which you can't control. With commercial real estate, you have much more control over the value of the property: if you maximize rents and minimize expenses, you will increase the net operating income, and that will increase the value of the building.

This makes apartment building investing more predictable, stable, and more easily understood by banks and investors.

### Reason # 4: Apartment buildings produce passive income

Everyone wants passive income. But what business can reliably produce a reasonable return without requiring your full-time involvement? The answer is, of course, apartment buildings, one of the few businesses you can set up to produce passive income.

Using a professional property manager not only frees up your time, but also ensures the building is managed properly. Once an apartment building is stable and the property manager is performing, your involvement in the investment can be minimal, allowing you to spend your time elsewhere (finding new deals, or spending time with your family!).

**Reason # 5: Investing in Apartment buildings is less risky**

As an investor, you always try to balance risk vs. reward. Investing in apartment complexes can yield a reasonable return at a relatively low level of risk. Want proof? Why else would banks so readily finance the purchase of apartment buildings? Because in their mind, commercial property presents an acceptably (low) level of risk to them.

**Reason # 6: It's the most teachable investment in the world**

Imagine starting from zero and wanting to learn how to start a software company or run a restaurant. How would you go about doing this? Is there a course you could buy? Coaching? Books?

The answer is probably "no" because starting any of those businesses is really hard. Most people who have these businesses grew up or have lots of experience in that area before starting out on their own.

Apartment building investing is different. You can learn it, then do it. Will you make mistakes? Yes, you will. But the point is, with apartment building investing, you **can** buy books, attend seminars and find coaches. It's one of the most teachable business you can start.

## How to Retire Early by Investing in Apartment Buildings - A Case Study

Imagine if you could do a single apartment building deal and retire from your J.O.B?

Imagine working really hard to find a good building at a fair price, putting the financing together, and hiring a property manager to run the whole thing. Was that a lot of work? Of course. But don't you work hard anyway?

Here's the difference.

Imagine the day you close on the building and your property manager takes over. Ask most apartment building owners, and they will say they spend anywhere between 2 and 5 hours per week on their building if it's managed by a professional management company.

What have you done? You went from a job that took 40-50 hours of your time each week to one that takes a fraction of that. And you replaced part or all of the income of your job with that from the apartment building.

You're working less while maintaining your income.

What would this mean to you? Maybe you could spend more time with your family. Maybe you want to travel more. Pursue a hobby. Give back. Or maybe do more deals.

How is something like this possible with apartment buildings? The answer is in how apartment buildings are valued.

The value of an apartment building is driven by its net operating income, the amount of income left after all expenses are paid. The more money the building spits out after all expenses, the more it's worth.

In many parts of the country, a building is worth 10 times its net operating income. This "10 times multiplier" is referred to as the "capitalization" or "cap rate" for short. Don't worry about this for now - it's not important to the point I'm trying to make. Let's just use a cap rate of 10 for our discussion.

Let's say a building has a net operating income of $100,000, which would make it worth $1M. If you could somehow make the building generate $10,000 more each year, maybe by increasing rents or decreasing expenses, you would have generated $100,000 in value (a cap rate of 10 times the additional income of $10,000 is an additional $100,000 in value).

Let's look at a more specific example, so that you can start visualizing how this "math" could work for you in real life.

Assume you bought a 10-unit building for $540,000, and you had to put 30% down. The building was bought at a "10-cap" based on our formula we've used so far. Which means its net operating income (or NOI) is $54,000 per year, times our cap rate of 10 is $540,000. The income per unit is $1,000, and the expenses are 55% of the income. The building is in great shape and has been managed by the owner himself.

So far there is nothing special about this deal.

However, suppose you found out that the average market rent in the area is actually a $200 higher per month. Suppose further that you meet a property manager who manages two similar buildings in the area, and he tells you that his expenses are only 45% of income.

Let's say it takes us 3 years to get the building to where it should be, i.e. with each unit bringing in $1,200 per month and lowering our expenses to 45% of income. Here's how this would impact our financials:

| | Now | After 3 Years | Difference |
|---|---|---|---|
| # Units | 10 | 10 | |
| Purchase Price | $540,000 | | |
| Downpayment (30%) | $162,000 | | |
| Rent per Unit | $1,000 | $1,200 | |
| Income | $120,000 | $144,000 | $24,000 |
| Expenses | $66,000 | $64,800 | ($1,200) |
| Net Operating Income | $54,000 | $79,200 | $25,200 |
| Debt Service (30% Down, 6% at 25 | $22,680 | $22,680 | |
| Cash Flow | $31,320 | $56,520 | |
| Monthly Cash Flow | $2,610 | $4,710 | |

By making small improvements each year, we have added $25,000 to our Net Operating Income. What is our value now?

Your new NOI is $79,000, so our value now is about $790,000 ! That is an increase of $250,000 in three years! Isn't that incredible?

But that's not all.

You also had between $2,600 and $4,700 in monthly income from this building over those three years.

That's still not all. You (emm, I mean your tenants), paid down $21,500 of your mortgage balance during that time, too.

Here's what you get if you add everything together:

| Cap Rate | 10% | 10% |
|---|---|---|
| Value | $540,000 | $792,000 |
| Appreciation | | $252,000 |
| Reduced Principal | | $21,456 |
| Combined Cash Flows | | $10,980 |
| TOTAL PROFIT | | $284,436 |

Your down payment was $160,000, and your total profit if you sold this building in 3 years is $284,000. This means you nearly doubled your investment!

In the meantime you enjoyed an average of $3,500 per month in cash flow.

Maybe you need more than that each month to quit your job. No problem. Buy a bigger building. Or get a second or third one. Three of these buildings will give you $10,000 per month in income and almost a $1M of profit in 3-5 years.

Would it be a lot of work? Absolutely. Do you work pretty hard right now? Probably.

Imagine working just as hard for the next 5 years and being able to retire. Imagine. 5 years.

And then you can do whatever you want. Keep working. Keep finding new deals (why stop?). Travel. Family. Give back. Whatever.

You don't have all the answers, and you probably feel overwhelmed. That's to be expected. The point I'm trying to make is, make sure that whatever you're working hard at gets you to where you want to go.

It's like you're climbing the rungs of the professional ladder and after many years, when you get to the top, you discover it was leaning against the wrong wall!

For me, and many others, apartment buildings are the single best way to retire early. It might be a good wall to consider climbing. Why not get started today!

**In conclusion, apartment building investing is probably the most reliable, repeatable and teachable way to generate income and retire early. It's not a get-rich quick scheme but with persistence and time it's one of the best ways to achieve your financial goals.**

# Chapter 1: How to Raise Money from Private Individuals to Fund your Deals

## Why You Should Raise Money to Buy Apartment Buildings

Frank is a newbie apartment building investor. He told me he would seriously start looking for deals (i.e. making offers) once he had enough money to invest. But he couldn’t really tell me when that was going to be.

He said he couldn’t see himself putting a building under contract right now because he didn’t have the money to close. Who would take him seriously?

Frank had trouble seeing beyond his own reality, and so I suggested an alternate perspective. What if he raised money from friends and family?

He wasn’t sure how that would help. And besides, his friends and family didn’t have any money anyway.

I hear these objections to getting started with investing in apartment buildings all the time. People don’t have the money, and so they’re stuck. Looking off into the distance they mumble “some day”.

Some day.

The truth is, you don’t need tons of your own money or good credit to get started with apartment building investing. The secret to getting started now is to raise money from private individuals.

Here’s why.

- **You don't need your own money.** I hate stating the obvious, but since the lack of money is the biggest objection to getting started with apartment investing, it deserves to be stated plainly. Just to re-emphasize this point, if you raise money from investors you don’t need to use or have any of your own.

- **You can get more deals done.** Even if you have your own money to invest, there are only so many deals you can get done. On the other hand, if you are able to raise money from others, the sky is the limit. Your ability to accumulate property is then only limited by your ability to find worthwhile deals. The ability to raise money is an incredibly valuable skill to have.

- **You can do bigger deals.** With the backing of investors, you can go after bigger (and more lucrative) deals.

- **You have more eyes on the deal**. Richard Feynman, the famous physicist, once said that “the first principle is that you must not fool yourself and you are the easiest person to fool.” When you’re using your own money, no one else is looking over your shoulder, and you’re more likely to make mistakes. If you can convince others to invest in your deal, chances are, you actually have a deal worth doing.

However, there are some disadvantages to having investors:

- **You now need to report to your "bosses".** Chances are you'll have to report to your investors in one form or another. You may have to give updates and financial reports to your investors to keep them posted. This certainly is more work than if it were just you in the deal. On the other hand, analyzing the Profit & Loss (P&L) statements and sending out reports make you pay more attention to the deal. You should do the same if there are no investors, but few of us have this kind of discipline, and as a result we don't pay as much attention to the investment as we should.

- **You may lose some control**. You may not be able to make all of the decisions without a vote from your investors. As I'll discuss later, there are ways to mitigate this risk with how you structure the deal.

- **You won't get 100% of the profits**. That's true, but as the saying goes, 100% of nothing is still nothing. If you can own 100% of the building by using your own money, great. But if not, use investor money and get in the game!

All in all, though, the advantages of using other people's money far outweigh the disadvantages. This doesn't mean you shouldn't use as much creative financing as you can (especially seller financing). Bottom-line, if you get skilled at raising money from others (like Donald Trump!), you can get started with investing in apartment building TODAY.

## 3 Tips to Find Your Potential Investors

*For several years before getting involved with apartment buildings, I was renovating houses, fixing them up and reselling them. To finance these "rehabs", I raised the money from friends and family. The minimum investment was $25,000 and paid I them 12% to 15% simple interest, guaranteed by the house. The title companies took care of the promissory note and recording the deed. It was simple and well-understood by everyone involved.*

*People like and trust real estate, the returns were reasonable and the perceived risk was low. It was surprisingly easy to get friends and family to invest for these reasons.*

*As I was eyeing commercial real estate, I polled my existing investors to see which ones were interested in buy and hold commercial real estate or if they could refer me to anyone who they thought might be interested.*

*Only a few of my existing investors were interested in apartment buildings. From that perspective my pre-existing relationship didn't produce direct results. But they referred me to people who they thought might be interested.*

The lesson here is not that you too should start small first (with rehabbing houses, for example) before moving into commercial real estate. The lesson is that you should utilize your existing sphere of influence to achieve what you're looking for - in this case, to raise money for apartment buildings.

### TIP # 1: Talk to Everyone You Know

It's surprising who is in the sphere of influence of your family, friends, neighbors and co-workers. Never discount anyone - tell everyone you know what you want to do and you will be surprised at what will happen. Always follow up with a lead from someone you know. Even if that person will not invest, she may invest later or she may be able to refer you to someone else.

The conversation might go like this after you dispense with the small talk:

**You**: "I'm working on something new, maybe you can help."

**Susan**: "Oh?"

**You**: "I'm looking to purchase an apartment building in the <...> area with a group of investors. The annual returns are expected to be around 13% and the minimum investment is $50,000. You wouldn't happen to know anyone who might be interested, would you?"

Susan might say, "Well, I might be interested," or she might refer you to someone, or she might say that she doesn't know anyone.

If she is personally interested schedule a meeting with her. If she knows someone, ask her to make an introduction and then follow up with that person. Make sure you keep Susan informed about the progress.

Your goal is to have as many in-person meetings with potential investors as possible.

A couple more tips:

- It's important that when you invite someone to that first meeting that you **communicate the minimum investment amount**. Otherwise, if you're looking for a minimum $50,000 and the person only has $10,000 to invest, you're wasting everyone's time. By the same token, if the other person accepts the meeting, then they're implicitly saying that they are capable of and potentially interested in investing at that level.
- **Don't "discriminate".** Often it's impossible to tell who has money and who doesn't. It's amazing how much seemingly "low-key" people have stashed away in their IRA accounts. Similarly amazing is how little money the flamboyant stock broker neighbor next door has to invest in anything besides his boat and second house.
- Therefore, **"EVERYONE" is the key**: Talk to everyone, ask everyone for a referral, and follow up with everyone.

If you talk with each person you know today, and follow up with referrals, you will be amazed at how much money you'll be able to raise to invest in apartment buildings.

### Tip # 2: Email All of Your Contacts

Send an email like the one below to everyone you know:

*Hi Brad …*

*Here is more info about the investment opportunity. I'm looking for investors interested in a 9%-15% average annual return over 5 years by investing in multi-family apartment buildings in the Mid-Atlantic area. The minimum investment is $100,000. They can also invest with their 401(k) or IRA (please ask me how).*

*Our strategy is to purchase $2M - $5M assets that are stable but present an opportunity for us to add value. Investors will receive monthly updates, and cash flow distributions are made at the end of each calendar year. Investors have the option of getting cashed out of their investment between year 3 and 4. Attached is a one-pager with some more details.*

*If you know anyone who might be interested in a phone call to discuss this further, please drop me a line at […].*

*Thanks!*

**TIP**: The one-pager referenced in the email is in the Document Library > Raising Money from Investors > One Pager.doc. That same directory also contains Intro Emails.doc which contains a couple example of emails you can use.

Thank everyone who responds, regardless of response. Follow up with anyone who has a lead.

Your goal is to have as many in-person meetings with potential investors as possible.

Because you mention in your email what the minimum investment is, anyone who takes a meeting with you is most likely qualified to make that kind of investment. That means you won't be wasting your time with someone who doesn't have the kind of money you require.

### Tip # 3: Keep the Number of Investors to a Minimum

What do you think is easier for you to manage if you are looking to raise $500,000: (a) 100 people who invest $5,000 each or (b) 5 who invest $100,000 each?

You might think (a) because it's easier to find people with $5,000 to invest, and that is certainly true. But it takes as much "work" to raise $25,000 as it does $100,000. In fact, the process and conversation is the same, except that you're talking to a different person (one with more money to invest).

In addition to being about the same amount of work, you'll have an easier time managing 5 investors than 50. You will find that even though most investors are kind, patient, and understanding, there will be some that will be a pain. They will question you, ask about their projected returns, ask for their money back, or ask for more frequent reports, etc. The more of these kinds of investors you have, the more stressful your life will be.

Keep the number of investors to a minimum and shoot for no more than 5-10 investors per deal. Set your minimum investment amount accordingly. So, if you want to raise $100,000, make the minimum investment $25,000. If you want to raise $500,000, make the minimum investment $50,000.

It's just as much work to find 10 investors who can invest $50,000 as it is finding 10 who can invest $25,000. The difference is that it may take you a little longer to meet those kinds of investors. But it's a lot better than managing 20 investors who invest $25,000 each to raise a total of $500,000. Avoid that mistake, do the work upfront!

## What Apartment Building Investors Want and How to Give it to Them

If you can offer an acceptable level of risk with a reasonable return you should have little trouble finding investors to buy apartment buildings. But what are investors looking for?

The answer is, it depends, but here are some guidelines. You can then test the terms you're offering by discussing them with your potential investors and see what is the most attractive to them. Let's look at some of the things investors want:

**Minimal Risk and Downside**

The investor's # 1 concern is losing part or all of their capital. You need to make the investor not only comfortable with you but also with the asset you're going to purchase.

Investing in apartment buildings can yield a reasonable return at a relatively low level of risk. This is why banks so readily finance the purchase of apartment buildings (versus other businesses). Your investors will likely agree that commercial real estate presents an acceptably (low) level of risk to them. This is definitely an advantage when raising money.

Before you start talking to an investor about all the money they're going to make, spend more time making them comfortable with you and the investment. Otherwise they won't be in the mindset to listen to anything else you're going to discuss with them.

**Reasonable Returns**

Once you've addressed the perceived risk of the investment, then, and only then, can you begin talking about the potential returns. If you can offer investors an 8%-15% average annual return on their money, you will get their attention. On the other hand, mentioning returns around 20% tends to raise suspicions.

Investors measure returns in at least two ways: (1) what they are getting paid each year, and (2) what their overall return will be once the property is sold or re-financed.

# 1 is typically measured by the cash-on-cash return, i.e. what percent of their investment is paid out each year as distributions. Investors like to see at least something paid out as distributions, and are normally happy with a 3% - 10% cash on cash return.

# 2 is measured by a combination of how much cash was distributed each year, how much of the loan was paid down, and much the property appreciated over the life of the investment. In the current market environment, investors tend to be happy with a 8% - 15% average annual return.

**Equity and Profit Split**

In return for their cash, investors are looking for equity in the property. For deals under $2M, try to make sure that investors get at most 80% of the asset, leaving you with at least 20%. As deals get larger, your portion of the equity may decrease to 10% or 15%.

How you're going to slice the pie is determined by whatever it takes to achieve the target return for the investors. For example, in order to achieve a 12% average annual return, you might have to give the investors 75% equity. But maybe the deal is so profitable that you can achieve the same result by giving them only 60%. It all depends on the deal.

**How long will my money be tied up?**

Investors are concerned with how long you will tie up their cash. Your preference is to have investors on board for as long as possible, and your investors want their money back as soon as possible. I insist on a minimum term of 5 years but I allow them to ask for a liquidation after three years. This addresses the investor's concern that their money will be tied up for too long. A request for liquidation means that I will put up their shares for purchase to the other investors if they want to buy out that investor. The valuation of that investor's shares is defined up front in the operating agreement so that there is no bickering. If no investor wants to buy out the investor who wants out then there is no liquidation event. In other words, I am not obligated to buy out the investor, but I will try.

**Minimal investment**

Finally, you need to specify what your desired minimum investment is. I have found that many investors agree to invest the minimum amount, even if they're capable of more. What should your minimum be? My rule of thumb is to not have more than ten investors per deal. So if you're looking to raise $500,000 then the minimum investment should be $50,000.

Now that you know what investors look for and some rules of thumb, the next step is for you to "test" these with your investors to see what appeals to them most. Ask them hypothetical questions like "if we could achieve a 10% - 12% average annual return, how interesting would that be for you?" and "how long would you feel comfortable in tying up your money?". Once you've polled a handful of your investors and you can see a consensus building, you can position the terms to attract the most capital for your commercial real estate investment.

## Why to Avoid Taking Money from "Sophisticated" Investors

Sometimes when I speak with investors who want to syndicate their deals with investors (good for them!) they tell me they're paying an 8% preferred rate of return and giving the investors 80% equity. **Really?!?** So what does that leave for you?

If you pay out an 8% cash on cash return (which is already excellent!) there's either nothing left for you, or worse, there is no 8% cash on cash return and you have to push the obligation into the next year. If the building doesn't perform better, you might never be able to satisfy the liability to your investors and turn the situation into a negatively

amortizing loan! This means you're never getting paid **anything** while you own the building!

So you're already giving the investor most (if not all) of the cash flow, and then 80% of any upside? Wow, that's rich.

After berating the investor about how they won't get paid ANYTHING ever, I ask them who the investors are they're dealing with. That's when I discover that they're actually dealing with one or more "sophisticated" investors, or they are trying to copy a deal from an experienced investor who is working with sophisticated investors.

## What "Sophisticated" Investors Want and Why You Probably Don't Want to Take Their Money

Sophisticated investors are investors who invest professionally. These could be "angel" investors or institutional investors. These types of investors have access to lots of capital, see tons of deals, and can therefore be very selective about the deals they do. They've probably also been burned a few times, and so they construct the terms of a deal so that they are very much in their favor.

They will ask for high **preferred rates of return** and for a big chunk of any upside. They want to make sure they are paid before anyone else and they're looking for **high returns** (20% +). If things go wrong, they want to be the first in line to take the asset (and most probably your house).

### *Preferred Rates of Return*

OK, so what if your investors insist on a preferred rate of return?

A "preferred rate of return" means that the investors get paid a certain amount of any cash flow **first** and **before** you get paid. For example, if investors give you $100,000 and you agree to pay out a 5% preferred rate of return, then the first $5,000 of cash flow distributions are paid out to the investors first. The rest is split according to the equity split. If investors own 80% of the building, then they get 80% of whatever is left, and you get the rest. If nothing is left after paying out the preferred return, then you get paid nothing! And if the building doesn't have any cash flow to support such a pay out then it's deferred and owed the next year.

Obviously, this is good for the investors and not so much for you.

If you give investors a high preferred rate of return (like 8% or 10%), then give them lower equity (like 20% - 30%). This gives investors get a pretty good "guaranteed" return plus a little kicker if things go well.

If you offer a lower preferred return, then you can offer more equity.

Whatever you pick depends on what most of your investors want and the type of project you're investing in.

If you're taking on a shell of a building where there might not be any cash flow for 12 months, then a preferred return might not make any sense because there is no cash flow to distribute.

In general, investors like a preferred rate of return because it lowers the risk for them. But as we've seen, a preferred return is not good for you, the syndicator.

***The Time and Place for Sophisticated Investors***

I've dealt with "sophisticated" investors before and I've never taken their money because I didn't feel like there was a fit with me and the investment.

I think sophisticated investors have their place, but I'm just not ready for them at the moment. If you're buying a 150 unit for $7M and you need to give up 90% of the cash flow and equity, that still leaves a good amount for you as the syndicator. But apply that same logic to a smaller $1M deal and it's hardly worth doing the deal because there's very little in it for you!

You're ready for sophisticated investors when you want to raise BIG money and have a solid track record. If you don't have a track record, you'll be giving up too much to make up for the additional risk. If you do smaller deals with sophisticated investors, there won't be much left over for you.

So unless you're a seasoned investors and you've tapped out your extended network, let's talk about the two alternatives: friends & family and higher net worth acquaintances.

### Friends & Family

We've already talked about this investor: these are the people you already know: your friends, family, neighbors and co-workers. These people trust you for the person you are, and they will care less about the deal itself. They will invest with you simply because they trust you'll do a good job for them. Friends & family can typically invest or loan you around **$25,000** and often have that capital in their IRA.

Friends and Family are **delighted with a 8% - 13%** annual return because it's tough for them to get those kinds of returns any where else. So you don't need to offer higher returns like 20%!

I made this mistake when I first got started, and time and time again the response was, "Wow, that's an incredible return ... so, it's pretty risky, huh?" Not the kind of objection I wanted this early in the conversation!

Not only is this kind of return unnecessary, but it raises objections. So keep it more reasonable!

Friends and Family will NOT ask you for a preferred rate of return, so don't volunteer it! Preferred rates of return are good for the investor and bad for you. Unless an investor "forces" you to have one, then don't use it! Use a straight equity split instead. The equity split to use depends on the deal and on whatever it takes to achieve the 10% - 15% return for your investors. You can give your investors up to 80% of the deal (even though I shoot for less). If you have to give up more, then maybe you need to keep looking for another deal!

Also don't talk about any confusing investing concepts with this kind of investor. For example, don't mention "IRR" (internal rate of return) because your friends aren't going to

know what to do with that. Talk instead about the "average annual return" which is much simpler to understand.

Your friend will ask you, "if I give you $50,000, what will I get back in 5 years?". That question is answered not with IRR but with the average annual return. In simple terms, if after 5 years, the combination of cash flow, loan amortization, and profit at sale equals 50%, then 50% divided by 5 years is an average annual return of 10% simple interest return.

That's something that your friend will understand.

Your friend will also understand "cash on cash return", so it's OK to talk about that. They'll want to know what they can expect to be paid every year while they're investing in you.

Now, what if you want to raise more money than in $25,000 increments? You'll probably want to talk with higher-net worth individuals.

### The Higher Net Worth Investor

The higher net worth investor is oftentimes a successful business person or professional. This person can invest at a **$100,000** or higher level and has made some alternative investments outside of the stock market.

This kind of investor is still happy with a **12% to 15%** average annual return, even though they might have other investments with that kind of return, so you might be competing with other investments.

Most likely, this type of investors will **not ask for a preferred rate of return** or what the IRR will be, so don't volunteer this information. Basically, treat these individuals just like you would your family and friends.

The only difference will be the amount of minimum investment.

Be aware that you may have to deal with concerns and objections you didn't have to address with your friends and family. Higher net worth investors may ask you about more control of the entity that you will create for the investment.

With your friends and family, you can probably create an LLC where you have all the say and your investors have really no say whatsoever.

The higher net worth individual may ask for more control. They may allow you to make certain day-to-day decision but they will want a vote for decisions of a more strategic nature. This means you may have to give up more control and your investors will act more like a board of directors that could actually disagree with what you might want to do.

What's the lesson here?

**Don't take money from very sophisticated investors until you have a very established track record and are doing BIG deals.**

Unless you've done several deals and are looking to raise BIG money, you will most likely not be dealing with sophisticated investors. So don't volunteer a preferred rate of return and don't use confusing concepts like IRR. Keep it simple and focus like a laser on achieving the returns for your investors you projected, and they will invest more with you and tell all their friends.

## The Secret to Raising Money

Most new investors never seriously start with apartment building investing because of lack of funds. They say they'll start their investing career when they have money. But who knows when that will happen? And so they wait.

Or they'll say they can't see themselves putting a building under contract if they don't already have the funds in the bank - who will take them seriously?

Or how can they raise all of the money in time to close?

And how can they get money from investors when they don't have a building under contract?

It's a catch 22, and so they're stuck.

Let's address this RIGHT NOW. I will show you a secret that will let you overcome this problem by getting financial commitments from investors long before you have your first deal under contract.

This secret will let you

- get started NOW;
- allow you to make offers confidently; and
- get your funds so that you can close in time.

**The Secret to getting financial commitments before you have your first deal under contract is to create a Sample Deal Package**.

You create a deal package of an actual deal. Everything about the building is accurate (photos, location, financials, etc), except that you don't have it under contract. You may also lower the price so that you achieve the desired returns for the investors. In other words, you approach your potential investors with a deal package that looks like the real thing.

You can then say, "I don't have a deal right now, but when I do, it'll look substantially like this" and then you show them the package.

By the time you get a building under contract, you've already primed your investors, which will allow you to raise the money quickly.

Let's get more specific ...

## How to Create a Sample Deal Package

In this section we'll go through step-by-step how to create a Sample Deal Package.

### Step # 1: Get the marketing package and financials of a building for sale

The first step is to find a property that is being marketed for sale. This property should be about the same size and in the same area that you are looking for. It should have a good marketing package, i.e. it should have photos, financials, rent roll, unit mix, and maybe some information about the area and demographics.

It's easy to find a property like this: go to www.loopnet.com, create an account, log in, and search for properties that match your criteria. Sometimes you can just download the marketing and financial package. Many times you need to contact the broker and complete a non-disclosure agreement to get access to the financials.

I have found that the marketing packages from the big national brokers like Marcus & Millichap, CBRE, Sperry Van Ness etc are excellent. They typically contain everything we're looking for plus extra goodies like rental and sold comps. Contact a Marcus & Millichap broker you find on loopnet, ask to be put on his email list, and ask him to send you one or more deal packages.

### Step # 2: Create Projections using the Syndicated Deal Analyzer

Run the deal through the Syndicated Deal Analyzer to determine the purchase price, investor terms and returns, and financial projections. All of these will be copied and pasted directly from the Syndicated Deal Analyzer into the Deal Package.

For step-by-step instructions on how to use the Syndicated Deal Analyzer, see Chapter 5 “How to Analyze the Deal with the Syndicated Deal Analyzer”.

### Step # 3: Modify the Sample Deal Package Template and Copy and Paste from the Syndicated Deal Analyzer

I have seen 27 page investor packages that looked fabulous and were incredibly detailed and complete. I don't think there's anything wrong with this once you have a REAL deal. However, for the Sample Deal Package I highly recommend keeping it short (i.e. less than 7 pages, maybe even a little less). Otherwise you're going to overwhelm the potential investor.

Remember, a confused mind says "no", and you don't want that!

Here's an overview of the main sections.

**Executive Summary**: This short section (half to full page) contains a summary of the investor terms (preferred rate of return, equity, projected returns, minimum investment, the term of the investment), a description of the property, and an overview of the business plan (renovate and raise rents, exit strategy, etc).

**Property Information**: This section contains a description of the property, some words about the area, and the unit mix. I also add the business plan for this property. For

example, if we're going to renovate the units and make other cosmetic improvements to raise rents, that would go in this section.

**Financials**: This section contains the rent rolls and actual financials from the Syndicated Deal Analyzer.

**Projected Financials and Returns**: This is taken directly from the Syndicated Deal Analyzer.

**About the Management Team**: Here you have a short bio of yourself as well as for some of your other team members, for example your property manager, attorney and CPA. If you have any other important partners, list them here. This section gives you credibility as someone who will be able to put a deal together and close.

**TIP**: Take a look at a finished Sample Deal Package in the Document Library > Raising Money from Investors > Credibility Kit > Sample Deal Package-New Hampshire.doc.

## How to Conduct Your First Meeting with a Potential Investor

By this point you will have completed your Sample Deal Package and have several meetings scheduled with potential investors. Each investor who agreed to your meeting already knows your minimum investment and is presumably OK with investing at this level (at least theoretically).

What should be the goal of your first meeting? Ideally, you should get some level of commitment from your investor.

In order to get a commitment from a person, you have to understand and address their greatest fear, which is that they will lose part or all of their principal investment.

In order to address this fear, you will need to identify the main risk factors and how you plan to mitigate them.

If an investor hears that this is an "unbelievably safe investment without any real risks" they will rightly grow suspicious. You will be much more credible if you are upfront about the risks and how you plan to address them.

### Step # 1: Address their Biggest Fear: YOU

You have two strikes against you as far as the investor is concerned. First, he doesn't know and trust you (yet) and second, you probably don't have a track record (yet).

You will spend most of the meeting making the investor comfortable with you. Only then can you address other objections and the deal itself.

Your goal in the meeting, then, is to build rapport with the investor and demonstrate to him that you will be successful even though you don't have a portfolio of successful deals yet.

I start by talking about my life. Where I was born, about my family, where I grew up, and went to school. Remember, your goal is to build rapport, and sharing personal

information like this will achieve just that. Chances are you'll discover things you have in common.

Then describe your professional experience. Focus on a track record of success in whatever you have accomplished professionally. People can then see that you tend to succeed in whatever you do. If you had a failure, you can turn that into a strength by talking about what you learned.

Talk about your interest in buying apartment buildings. Why are you interested? What have you done so far to build your team? Talk about your team. Talk about deals you've looked at so far but passed on because the numbers didn't work.

At this point, you've done most of the talking, but that's OK. You shared about your life and your passion about building long-term wealth for you and your investors with apartment buildings. If you've done your job, your investor will say that he knows you a lot better and has become more comfortable with the prospect of doing business with you.

It's now time to shift the conversation to how you might do business together.

### Step # 2: Discuss your Sample Deal in General Terms

In this step, you want to outline the general terms of your Sample Deal. Keep it high-level and general. You don't want to overwhelm or confuse the investors. Remember, you should have already addressed their major fear, which is loss of principal. If the investor is comfortable with you and the general idea of investing with you, it's time to address the terms and potential returns of the deal.

Again, keep it high-level.

**You**: "I have a deal for us to look at. I don't actually have this building under contract, but when I do have a deal, it will look substantially like this. I wanted to get your feedback on the terms and projected returns, would that be OK?"

**Investor**: "Sure!"

**You**: "The deal I'm looking for should produce an average annual return of 9% to 13% over the life of the investment, how interesting would that be to you?"

**Investor**: "That would be interesting to me. How long would the money be locked up?"

**You**: "I'm telling investors that they should be prepared to keep their money in for at least 7 years - this would allow us to build the value we're looking for. I realize this is a long time. In order to address that, after 4 years I would allow an investor to pull out by offering to sell their shares to other investors. The LLC operating agreement would spell out exactly how that would be done. How would you feel about that?"

**Investor**: "That would be fine. Would there be any cash flow distributions?"

**You**: "Yes. Typically, we will pay out distributions once per quarter, how would that work for you?"

**Investor**: "That sounds reasonable. What do you see as the greatest risks?"

**You**: "It would depend on the deal. I think the greatest risk is our ability to execute our business plan. We could fall short of our projected returns or it might take more time to achieve. For example, let's say our plan calls for the renovation of half of the units so that we can raise rents by 30%. We would make sure we have the money in the bank account to fund the renovations. But maybe the tenants won't move out as quickly as we think and it will take longer to raise the rents.

"Having said all that, my goal with the first few properties we buy will be to keep these kinds of risks to a minimum. In other words, I don't want a completely vacant building or a building with all kinds of problems. I'm going to look for a good deal for a relatively stable building.

"Once I have a building under contract, I will outline the plan in more detail and identify the risks so that you can make a better decision.

"Before we look at the Deal Package, what other questions or concerns do you have regarding the returns and terms we talked about so far?"

At this point, the investor should be relatively comfortable with you as a person as well as with the risks, returns, and terms of the investment.

### Step # 3: Take a Peak at the Sample Deal Package

Next, spend a little bit of time reviewing the Deal Package itself. Don't spend too much time because you probably don't have too much time left in the meeting anyway, and the numbers aren't for a real deal.

But you do want to review the outline of the deal so that when the investor goes home, the investor won't be seeing it for the first time.

**You**: "Let's take just five minutes and look at the Deal Package. Like I said before, this is not a deal I currently have under contract, but when I do, it will look a lot like this."

Then briefly go through each section of the Deal Package, just enough to orient the investor and answer any questions. Don't focus on the numbers since these will change.

### Step # 4: Describe the Closing Logistics

Finally, you want to close by describing the logistics of closing on a deal from the investor's perspective. Keep it hypothetical, something like this:

"Let's assume you decide to participate in the next deal. I'm not saying you will, but let's say you do. Here's what would happen next.

I'll keep you posted and when I have a property under contract, I'll email you the Deal Package. If you're still interested in investing, you just have to tell me the amount you're interested in and I will reserve that amount. Once I get commitments from all of the investors and the due diligence is satisfactory, I will instruct the attorney to begin the closing process.

At that point you're going to receive a bunch of documents to review and sign. One of the documents will be the Operating Agreement, which is basically the contract

between you and myself. It describes how profits are distributed, how decisions are made, etc.

Once that is satisfactory, you would wire the funds to the closing attorney.

My goal will be to send an email report to the investors once per month in the beginning, and once things have stabilized, I will send out quarterly reports with any distributions.

What questions or concerns do you have about this?"

### Step # 5: Take a Pulse

At this point, the investor should have a TON of information about you and about the potential deal you're contemplating. The investor will have formed an opinion about investing with you. Now it's time to see where he or she stands.

**You**: "We're almost wrapped up here today. Thanks again for your time by the way!"

**Investor**: "Sure, it's been interesting!"

**You**: "So, based on everything we've talked about today, how interested would you be in participating in the next deal?"

And then see what he or she says. Address any concerns. Don't push too hard, but be encouraging.

### Step # 6: Agree on Next Steps

Make sure you agree on next steps. You want to make sure you have a reason to talk with the investor again.

Maybe the investor wanted to think about it some more, talk with his wife, or check his IRA holdings. In other words, he didn't commit to you 100% but said he was interested. You need to follow-up with that person in the time frame you agreed on and push him to either a "yes", "no", or "not right now" (and in my world the last two are the same!).

Then touch base with that investor every couple of weeks to let him know what's going on and that you're still looking for a deal.

As more time passes, the more likely it is that the investor's situation changes. This could mean that he was committed at one point, but then he lost his job or had an illness in the family which required additional resources. Or, the investor got a promotion or inherited some money and he now wants to invest more.

It's important to touch base with your investors every once in a while to see at what level they are committed.

### Conclusion

At this point you should have had several meetings with potential investors. Track your conversations and activity somewhere, like in a spreadsheet. Also capture what dollar

amounts each investor is interested in. You can add up all of your commitments so that you know how much money you can reasonably expect from your investors.

Expect 25% of your investors to drop out, so make sure you raise 25% - 50% more than you really need.

Some of your investors may have asked you for details about how you will structure the LLC. After the following several sections, you'll know how to answer those questions when they come up!

## What Kind of Legal Entity Should You Use?

**To start with, make sure you NEVER buy anything in your own name.**

In most cases, you'll want to use an LLC. An LLC provides the right level of asset protection for you and is the simplest to set up, administer and tax. I generally set up a separate LLC for each building. That way, if something bad happens (like a lawsuit), then it might take down the one ship but hopefully not any of your others!

For more complex investments (that we'll touch on later) you may want to consider setting up Partnerships, but for now (and for most situations) the LLC is the way to go.

### How to Create an LLC

It's fairly easy to create an LLC. The process differs slightly by state, but in general you search for an available name and complete an application and pay a fee. Many times you can do this online and you have your LLC registered in minutes. To get the details in your state, just Google "how to register an LLC in <State Name>. The final step is to get a Federal Tax ID for the LLC, which you can do on the IRS web site www.irs.gov (Google "Apply for an Employer Identification Number (EIN) Online"). In some jurisdictions you may require a business license, though this is rare for owning real estate - just make sure you check first.

Using the LLC certificate and Federal Tax ID number, you can open a bank account. You now have what you need to conduct business using your LLC.

I also recommend Nolo's book " Form Your Own Limited Liability Company" which gives you many more details about what you could possibly add to your operating agreement, and also what to do each year to maintain your LLC as a valid company.

### Introduction to the LLC Operating Agreement

The LLC's Operating Agreement can be a simple one pager or dozens of pages long. A more complex Operating Agreement can define who can make what decisions, how these decisions are made, how people can be added or removed from the LLC and other details.

You can download sample Operating Agreements from the Internet, and I will also review some of mine with you. But at the end of day, you need to have a competent attorney create one for you or review the one you provide (in fact, you're welcome to modify the two templates I give you in the Syndicator Legal Library and save thousands of dollars in attorneys fees!). Your attorney may charge you $500 - $1500 for an operating

agreement, depending on the complexity. Even though you might be the LLC's sole member, the LLC is a separate entity from you, and the operating agreement defines how that entity is governed. A good operating agreement gives you credibility with others and will provide the proper legal shield if necessary. Don't skimp on this step!

## 5 Ways to Structure the Investment

How you structure your investment depends on the size and complexity of the investment. Regardless how you end up structuring the deal, ALWAYS do so with a legal entity - never in your own name.

OK, let's look at different ways you can structure an investment, ranging from the simple to the more complex, depending on what you need.

### Option # 1. You are the Sole Member of the LLC and have no Investors

If you are the only owner and have no partners or investors, the deal structure can be relatively simple. You register an LLC and have a "standard" operating agreement, in which you are its one and only member (called the "Sole Member") and you assume the role of every manager (i.e. Officer) in the company. You meet with yourself once per year and add the notes of your annual meeting to the LLC binder.

This may seem a bit silly, but these formalities are necessary to maintain a valid LLC.

With regards to your deal, your LLC will be the owner of the building. You wire your funds to the closing, and the title attorney will handle the rest.

### Option # 2: You are the Sole Member of your LLC and you are Borrowing Money from Investors

In this scenario, you are borrowing money from your investors. You sign a promissory note with each investor that outlines the principal borrowed, the interest rate, and repayment terms. Maybe you agree to pay 10% interest per year (paid monthly) and repay the principal in a lump sum in 5 years. The investor would get the original promissory note that is also referenced on the Deed and recorded to protect the interest of the lender. The lender, however, has no voting rights whatsoever in your LLC. As long as you don't default on your loan to them, they are happy.

The Deed and Promissory Note can typically be handled by your title company.

This option would work well if you want to purchase a building in cash because it requires a ton of work. Once you've renovated and leased up the property you could re-finance and repay the investors.

You could also combine this option with a traditional commercial loan. Your investor's loan would essentially be a second mortgage. Just make sure the cash flow of the building supports all of the debt service. Also, make sure that there is a high degree of probability that you can repay the balloon note in the time you agreed. Normally this strategy relies on your ability to add value and re-finance (or sell).

**Option # 3: Your LLC has multiple Members.**

In this scenario, you are NOT borrowing money from investors, but instead, they are contributing EQUITY to the LLC. You, too, are one of several members of the LLC, and all members have the same voting rights. Each member owns an equity and a voting rights percentage. If your operating agreement calls for a majority vote of the members to sell the building, for example, then you get to cast your vote along with everyone else, and if you want to sell the building, you will need a majority vote.

You will likely hold one or more of the manager/officer positions. Officers typically can make the day-to-day decisions but must defer to the members for votes on more strategic matters (like selling and re-financing the building).

While it may seem that you're giving up control (which you are), the reality is that most of your investors will vote for whatever you recommend. While technically they could vote against you, this probably won't happen in reality. They trust that you will do a good job for them and will just go along with what you suggest.

So the structure is fairly simple: you have the investors (i.e. "members"), of which you are one. And then there is the Manager (or "officers") of the LLC, which will be you. For many projects, this arrangement is perfectly adequate, especially if you have mostly friends and family investors who will defer to you to make decision and will vote with you if a vote is required.

If you require a finer degree of control for you and your investors, Option # 4 may be for you.

**Option # 4: Two Classes of Members**

In this scenario, your operating agreement calls for two different classes of members: the Investing Members (your investors) and the Managing Member (you). And then there are the Managers or Officers. You can use this structure to separate and fine-tune your decision-making ability from that of your investors. You can use this to give you ALL decision-making authority or you can use it to give more control to the Investing Members.

What you do depends on what you and your investors want to do, but this structure gives you the greatest control.

You could make it so that the Investing Members hardly have any say at all and the Managing Member (you) can call all the shots.

Sometimes, your more sophisticated investors will want more control. They may want to vote on matters such as re-financing or selling or maybe even selecting a new property manager. Typically, the Investing Members will give you a sandbox to make decisions in, but if

**TIP:** Please review the *Operating Agreement Template.doc* in the Syndicator Legal Library. This operating agreement implements what we described here in Option # 4. You can modify it to meet your needs, then give it to your attorney to review and finalize.

you want to do something outside the sandbox, they will want a vote.

In this way, you can spell out exactly what the investors can and cannot do. If your investors are a bit more sophisticated and want more control, you can give them more control. If you want to make them mostly silent, you can do that too.

**Option # 5: If you want an entity with which you can purchase additional properties in the future**

If you plan to do multiple deals over time with your investors, you can create a Limited Liability Limited Partnership (LLLP) that owns one or more LLCs. Each time you do a deal, you create a new LLC that is wholly owned by the LLLP. The partnership agreement defines how this is done and how many is added to the LLLP. This structure significantly reduces the legal expenses of doing multiple deals.

The LLLP has Limited Partners (or "LPs", which are the investors) and then there are one or more General Partners. In my case, the General Partners (GP) consisted of me (the primary sponsor) and another co-sponsor (this could be one of your investors who you want to be more hands-on with you; or perhaps you want to partner with your property manager).

The General Partners have a sandbox to play in, but the LPs have a vote for more strategic matters (including re-financing, selling, and retaining earnings above a certain point).

The LLLP provides a mechanism for "capital calls". Capital calls is an instance where the LLLP requires more capital, such as to purchase an additional property. The GP, having ratified a contract to purchase an additional building, can request a capital call of, say $500,000. This, then, calls for a vote by the Limited Partners. If the vote is approved, then the Limited Partners have the ability to contribute their pro-rata share, but they are not required to do so. But their share will be diluted proportionally. Other LPs can contribute more as well.

If the capital call is not satisfied, i.e. if the $500,000 was not raised by the LPs, then the LLLP can have a provision to add additional LPs, who can then contribute the required capital. A capital call may change the equity structure of the LLLP.

The new building is purchased in a new LLC, which is wholly owned and governed by the LLLP.

Using an LLLP in this way is a fantastic model that can be used repeatedly to add properties without the expense and hassle of a new private placement memorandum.

**TIP:** Please review the *Partnership Agreement Template* in the Syndicator Legal Library. This partnership agreement implements the LLLP we described here in Option # 5. You can modify it to meet your needs, then give it to your attorney to review and finalize.

## Other Things to Consider In your Operating Agreement

Here are some other things you might want to consider addressing in your operating agreements.

### Capital Calls

We mentioned this under Option # 5, but even if you don't go with that option, addressing capital calls upfront in the operating agreement is a good idea.

A capital call is when you need more money for some reason. Let's say you budgeted $50,000 to renovate 10 units but the cost is suddenly $10,000 more and the LLC doesn't have that kind of money. You could decide to forego the renovations but then your business plan (and returns) might suffer.

Or, you could decide to make a capital call from your investors.

You can set this up in your operating agreement from the start. Let's say you have the right to propose a capital call. Each Investing Member has the option, but is not required, to contribute their pro-rata share of the capital.

For example, if a member owns 10% of the building, they could contribute 10% of the $10,000, or $1,000. If every member contributes in this way, you will have raised the $10,000 and each member would maintain their percentage ownership.

However, Member A may choose not to participate, but Member B may decide to contribute Member A's share. Then Member A's ownership percentage goes down and Member B's will increase accordingly.

Adding a capital call clause into your operating agreement upfront spares you the hassle of negotiating something when you need additional capital.

### Buy-Out Clause

After several years, you can give your investors the chance to get out of the investment. You can do this to overcome the objection, "Seven years is too long to have my money tied up!"

After three years, if an investor wants out, the operating agreement defines the value of their equity as roughly "90% of fair market value (FMV)", FMV being defined as a multiple of net operating income. The key is to define how fair market value is calculated.

The other investors then have the option of purchasing that investor's shares at that value. If no investor wants to buy the other investor out, nothing happens. The investor can't force a buy-out.

However, it does provide a vehicle for a pre-defined buy-out without having to fight over valuation or hire expensive CPAs or appraisers.

## Avoiding Prison When Syndicating Real Estate Deals (Let's Talk About Securities Laws)

When you accept funds from others to buy an apartment building, you are effectively selling shares, or securities, in the LLC (or other entity) that will own the building. As such, they fall under federal and state securities laws.

These laws differ by state and by how complex the deal is. Typically you have to provide your investors with some kind of disclosure document, and you have to file some forms with the federal SEC and possibly with one or more states.

Most investments will fall under the SEC's classification of "small" offerings, i.e., not exceeding $5,000,000. The most important are those under Rules 504 and 505 of Regulation D. Under these rules, you can't raise more than $5M and have no more than 35 non-accredited investors.

The SEC defines "accredited" investors with a household net worth of at least $1,000,000 and an income of $300,000. There's no limit with how many of these types of investors you can have.

This impacts your fundraising only in the sense that you shouldn't have more than 35 non-accredited investors.

Under these rules, you also can't solicit strangers with your offering. This means you can't put up billboards, send out mail, or post newspaper ads. Well, you can, but if you do, you'll need to file under another Rule, and then some of the requirements change.

The SEC requires you (or rather, your attorney) to complete a "Form D" (download the form from the sec.gov here or see the sample in the Syndicator Legal Library > SEC Form D.pdf). Your attorney may have to file a similar form for every state that your investors live in. To see the form for Virginia, check out the Syndicator Legal Library > Virginia Form 1.

In addition to the filings, you'll also need to give each investor a disclosure document which is called the "Private Placement Memorandum" (PPT) ... let's talk about that next.

## The Private Placement Memorandum (PPM)

This disclosure document is usually referred to as a "Private Placement Memorandum" or PPM. The PPM is a rather long document with disclosures that are required to comply with securities laws.

The PPM contains the terms of the operating agreement, information about you and your professional successes and failures, information about your deal, that there are no guaranteed or promised returns), and a litany of possible risks and tax consequences.

**TIP:** Please review the *Private Placement Memorandum PPM Sample* in the Syndicator Legal Library.

The PPM is so specific to you and your deal that there's no sense in modifying this to save attorney costs. But you can do that with the operating or partnership agreement!

Tell your investors they should at least scan the document. They are not required to sign this document but they do have to acknowledge receipt of the document when signing the Subscription Agreement.

It's not difficult to comply with SEC regulations but it will cost you extra money to do so because a securities attorney will have to advise you and prepare this 60-90 page document**.** This can cost you $5,000 to $20,000 (and even more) depending on the size and complexity of the transaction.

**Should you issue a PPM to your investors?**

The primary purpose of the PPM is to disclose all potential risks of the investment to your investors and to ultimately protect you. If you **don't** issue a PPM and the deal goes south, your investors could contact your state's Securities and Exchange Commission (SEC) and file a complaint. The SEC may investigate the complaint. The first thing they'll check is if you've registered the proper disclosures. If you did, that usually ends the investigation, because you've complied with securities laws. If you didn't, the SEC may prosecute and fine you. The non-compliance may also hurt you in court if the investor decides to sue you.

You have to weigh whether spending $5,000+ on a securities attorney makes sense. If you do it, you can sleep soundly at night, not having to worry about the SEC breathing down your neck. On the other hand, we as entrepreneurs always take well-thought out, calculated risks, and not issuing a PPM could be one of those calculated risks.

If your investors are generally friends and family who will not likely become belligerent even if the deal turns bad, or if the building is small (hard to define, at what point will the SEC not investigate a complaint?), you may want to forego the extra expense and the PPM.

> *I was once party to a substantial investment venture that resulted in a total loss for the investors. One person actually did complain to the SEC, and the general partner was investigated. The outcome was a fine of $6,000 and an order for the partner not to take anyone's money for at least 5 years - in that particular state.*

Ask your attorney and other investors for additional data points. A good guideline is that if the asset is worth more than $500,000, try really hard to work in the cost of a PPM. But you have to decide for yourself what level of risk you're comfortable with.

## The Subscription Agreement

The purpose of the Subscription Agreement (SA) is for the investor to agree to the investment amount, acknowledge the receipt of the PPM, and disclose what kind of investor he or she is, meaning they are either an accredited or non-accredited investor.

> **TIP**: Please review the *Subscription Agreement Sample* in the Syndicator Legal Library.

An accredited investor is someone with a net worth of at least $1M or an annual family income of at least $300,000. The SEC considers these types of investors to be more

sophisticated than non-accredited investors and therefore fewer disclosures are required.

This classification is important to determine with which level of securities law you need to comply. For example, if all of your investors are accredited, fewer disclosures are required than if you have non-accredited investors. For most deals you do, unless you're doing big deals with lots of investors, you don't need to worry about the number of either type of investors. Your securities attorney will know all about the details and will guide you appropriately.

Back to the Subscription Agreement. Investors disclose what kind of investor they are (accredited or non-accredited). They acknowledge that they have received the PPM. And they commit to a certain investment amount.

## Working with Your Attorney

Don't get too bogged down with the technicalities of what we just covered. You don't need to be able to quote what exemptions mean what, and you don't need to. **Your SEC attorney will handle the details.** You just have to know enough to tell him what you want done. Even if you don't know exactly what you want done, he or she will ask you the right questions.

The only other thing you have to know about this is that it will COST YOU MONEY to hire an attorney to draft these documents. It normally costs upward of $8,000 (and usually more) to draft the operating agreement, PPM, and subscription agreement and to file the necessary SEC forms.

> *I found an excellent SEC attorney who "retired" from a huge expensive law firm that normally charges $20,000 for all of this, he charges me $6,000 for the PPM. He charges me half up front, and the rest can be paid at closing.*

Be sure that your attorney specializes in these kinds of deals and has done a ton of them.

### Conclusion

The details of being compliant with SEC regulations are complicated, and you should have your SEC attorney handle them. You need to know the basics as I've described them, and your attorney will educate you and handle all of the details.

## Unlocking Massive Capital in your Investors' IRA and 401(k) Accounts

Nearly $9 Trillion (that's trillion with a "T") is held in people's IRA and 401(k) accounts. It's amazing how much people have stashed away in their retirement accounts. And you can be sure they're frustrated by their returns and the uncertainty.

That is why they will be eager to talk with you if you have a way to have their "lazy" money return 8% - 10% per year with conservative real estate investments.

But most people don't know they can invest their retirement account money in something like apartment building deals. Your ability to explain this to your investors will

unlock a HUGE source of capital for you. People's IRA accounts have underperformed miserably for a very long time, and so your investors will be grateful to you for boosting their retirement earnings.

Here's how to use IRA funds to invest in apartment buildings.

The first step is for your investor to roll over part or all of their IRA accounts to a "self-directed IRA custodian", who manages the funds and makes sure you abide by IRS tax laws.

A self directed IRA is unique because of the available investment options.

Most IRA custodians only allow approved stocks, bonds, mutual funds and CDs. A truly self directed IRA custodian allows those types of investments in addition to real estate, notes, private placements, tax lien certificates and much more.

You may not have heard of self-directed IRAs even though the concept of investing in real estate and other assets in retirement plans has been around for more than 30 years. The concept hasn't received large attention because most custodians who offer IRAs (banks and brokerage firms) focus on mutual funds and CDs because they have vested financial interests in you selecting those investments from them.

If your CPA or financial advisor hasn't heard of self-directed IRAs, I would suggest they contact a self-directed IRA custodian to have their questions answered and become comfortable with the concept.

You can invest your self-directed IRA in almost anything. You can make a loan (like a promissory note) or you can invest in an LLC or other corporation.

There are specific rules regarding IRAs, and it is your IRA custodian's job you make sure everything you do complies with IRS regulations.

There are certain types of transactions that you can not perform through an IRA. Most importantly, the IRS prohibits "self dealing," which are investments in which you or your family members of lineal descent have prior ownership.

Here's how the process works to use your (or your investor's) IRA funds:

1. Open an account with a self-directed IRA custodian.

2. Contact your current IRA custodian and complete a funds transfer form. In this form, you specify the amount to transfer as well as the account information of your new IRA custodian. Note that this process may take up to a month.

3. Once your funds are in your new self-directed IRA account, you complete an investment directive form that informs your new IRA custodian about the investment you want to make and instructs them how to disburse the funds (by wire or check). Normally, the funds are sent directly to the title company handling your closing and are made out to the LLC that will own whatever property you're buying. The investment will be titled in your IRA's name (not your own personal name).

4. When you liquidate the investment you made with your IRA, the funds are sent from the title company handling the sale or re-finance directly back to the IRA custodian. You never get to touch any of the funds. They come from the IRA and go back to the IRA.

   *What I have done in the past is contact Equity Trust Company (the self-directed IRA custodian I use) to send me several folders with Frequently Asked Questions and application forms. I then hand these to investors who are interested in investing with their IRAs. It gives the whole thing a level of professionalism that adds to your credibility.*

There is a lot of cash in people's IRAs and 401(k)'s - cash that is earning very low returns. Educating your investors about using their IRA's will unlock an incredible source of funds for your deals.

## Chapter Summary

Whew, this was a long chapter! Here's what we accomplished:

- We talked about why it's such a good idea to raise money from private individuals to fund your deals.
- We revealed the secret to raising money, which is to create a Sample Deal Package.
- We covered how to find potential investors (talk to everyone you know and get referrals) and how to conduct that first investor meeting to secure financial commitments.
- We discussed different ways you can structure the investment as well as securities laws considerations.
- We talked about how investors can use their IRA money to invest.

You now know all you need to know about the logistics of doing business with your investors. You also know how to structure your LLC and to manage you attorneys to do what you want them to do. I hope that this chapter gives you the knowledge and confidence to raise as much money you need from private individuals.

Well done,  you deserve a break!

# Chapter 2: Select the Right Area In Which to Invest (Even Out of Area!)

In order to be successful with apartment building investing, we want to pick the right area to invest in, and then within that area, we want to find the right property.

Let's say we find a good deal in an area that is rapidly improving. While we don't want to rely on the local market to get better (that would be speculation, and we don't do that!), if the local market were to improve, that would mean our rents would go up and the cap rates might go down, both of which increase the value of the building. This is not only an added bonus for us, but it gives us a good margin for error in case we make mistakes.

For the first part of our discussion, I'm going to assume you're going to invest in your own back yard. This may not always be feasible, and we'll talk about how to invest out of area after that.

## 4 Tips for Investing in Your Own Back Yard

Where in your area should you start investing? Here are the things to look for.

### Tip # 1: Look for Areas that Meet Your Investment Criteria

Another consideration for picking an area is your investment criteria. We'll talk more about this in Chapter 6 when we analyze deals. The bottom-line is, if you want 15%+ returns for your investors and your area doesn't offer those kinds of opportunities, you may have to look outside your area.

The best way to determine this quickly is to call a few commercial real estate brokers and ask them about the area. Tell them what you're looking for. They'll tell you if deals like that can be had, and where.

Next, request marketing packages from active apartment building listings in your target area. You don't need to spend a ton of time analyzing these deals, just look at the advertised returns that are in many marketing packages.

### Tip # 2: Consider Investing in Class C Areas

Another thing you may have to consider is looking in not-so-nice (Class C) areas.

Class C areas generally have older, not-so-nice properties that are rented to largely blue-collar or even subsidized housing tenants. These are areas that may not be entirely safe after dark but are normally fine during the day. These may be areas that you're not completely comfortable with at first but should consider expanding your comfort zone for. I say this only because for the kind of returns we're looking for (for us and our investors), we may have to consider this asset class, but we may have to expand our comfort zone a bit.

Then there's Class D areas, which is basically the ghetto. I know of people who make good money in these areas, but it's not for me, and I don't wish to expand my comfort zone to include Class D. Anyway, that's just me.

**Tip # 3: Look for Areas that are in the Path of Progress**

Look for apartment buildings in areas that are improving. These areas are typically in the path of progress. Focus on areas in which the city is investing, i.e. roads, utilities, libraries, schools and other buildings. You can see that houses or buildings are being renovated.

How do you know if an area is improving? This is where local knowledge is key. You either have the knowledge yourself (because you are familiar with the area) or you can talk to people who know. Talk to local residences, real estate brokers, lenders and other professionals. Ask them which areas in the city are improving. Talk to the zoning and planning department and ask them to share with you their city plan. You want to be in an area in which the city is investing, that is bringing in outside investments, and that is improving with time.

**Tip # 4: Look for Value-Add Opportunities Within Those Areas**

Within the area(s) you've identified, you want to look for under valued apartment buildings to buy.

These are buildings that may have low rents, high expenses, or need renovation. We'll talk a great deal a bit later about recognizing value-add opportunities and ways to actually add value.

If you can get into a building like that in an area that is improving, you chances of increasing the value of the building over time greatly increases. That's what you want - the odds in your favor.

## When to Look for Deals Outside Your Own Area

Of course it's best to buy property in your area. You're more familiar with the area, and you're close enough to drive to the building when you need to. It's easier for you to build relationships with your team members. And your investors will be more comfortable with investing locally.

But if you live in an area where commercial real estate is expensive, finding good deals may be problematic. In that case, you may decide to pick another location that fits your criteria better. You may have to drive or fly more frequently as you build your team and make offers.

In other words, look locally if you can, but don't be afraid to venture outside your area. If you do decide to look outside your area, here's how to do it.

## 6 Steps to Buying Apartment Buildings OUTSIDE Your Area

Generally it's good advice to invest in apartment buildings that are within easy driving distance to you. Especially if you're managing the building yourself, the closer the building is, the easier everything is. That also means your team members (the property manager, attorney, brokers, etc) are all within an easy drive. And your investors will prefer to invest locally, too.

But sometimes you have little choice but to look for deals that are well outside your area. For example, if you live around San Francisco or New York, you may be frustrated at the complete and utter lack of good deals, and buying at a 5% cap rate doesn't really cut it for you.

What to do?

One option is not to do any commercial real estate investing.

The other option is to look in other markets.

> *When I first got started with apartment building investing, I started looking in Texas even though I live in Northern Virginia. I had taken a boot camp, and the guru recommended Texas. So I went looking in Texas. The first thing I did is to build my local team of commercial real estate brokers. I then interviewed commercial lenders, property managers and attorneys. I analyzed over 100 deals before putting an 82 unit building under contract.*

It will cost you more time and money than investing locally, but it can be done. Here are 6 steps for buying apartment buildings outside your area.

### Step # 1: Pick The Right Market In the Country

The area you select will depend on what you're looking for. What kind of returns are you looking for? Do you have family in a particular city or do you like a particular area of the country?

A good overview of apartment building market in major regional markets in the U.S. is the Marcus & Millichap Regional Apartment Reports (register and download here). Read the reports for the different areas in which you're interested.

I look for a combination of two things: growing employment (and population) and high cap rates. That is the PERFECT combination for apartment building investing. The Marcus & Millichap reports will help you identify these areas.

Once you identified your top 3 areas, then it's time to go a bit deeper. Contact the economic development offices in your chosen cities and request their annual report and outlook. You're looking for a growing local economy, new jobs, and investments.

Here are a few websites to track the commercial real estate market and economy for local markets as well as nationwide:

- Globest: www.globest.com: commercial real estate news
- Costar: www.costar.com: this site requires a paid subscription. But Google for "costar advisor" and sign up for their free, weekly newsletter with news and updates for up to three national markets.
- Multi-Housing News: www.multihousingnews.com: free commercial real estate news and market data.
- CP Executive: www.cpexecutive.com: commercial real estate news by region.

- Multi Family Executive: www.multifamilyexecutive.com: focus on apartment buildings
- NREI Online: www.nreionline.com: news segmented by area and asset type.
- REIS Reports: www.reisreports.com/blog: market and sub-market analysis , sales and rental comps (paid but with free trial)
- Realty Rates Cap Rate index: www.realtyrates.com/commentaryg.html

I suggest reading these sites regularly, focusing in on the top 3 areas that you're considering.

### Step # 2: Find Commercial Real Estate Brokers

The next step is to start calling commercial real estate brokers. An easy way to find them is by searching www.loopnet.com and by calling your local Marcus & Millichap, CBRE, and Sperry Van Ness offices.

In your first phone conversation, you want to introduce yourself and qualify the broker a bit. Your second purpose is to see what kind of deals are available in the area: ask about prevailing cap rates, cash on cash returns, price per unit etc. This will give you an idea of what kind of returns you can expect in this area.

Then have them put you on their buyer's list. Analyze the deals you get from them quickly and give them feedback. Call them weekly to stay in touch.

We'll talk more about building trust with commercial real estate brokers in the next chapter " The Single Best Way to Find Deals: Commercial Real Estate Brokers".

### Step # 3: Get referrals For Other Professionals

Once you've decided on an area to invest in and you've started to talk with several commercial real estate brokers, it's time to find your other team players. Next priority is to find local property managers, attorneys, and commercial loan officers or lenders. Start by asking your real estate broker for referrals, then ask everyone else you talk with for referrals also. Call everybody to whom you're introduced and track your conversations in a document so you can refer to it later (the names will start to blur after a while!).

We'll talk more about building your team in Chapter 4 "How to Build an A-Team".

### Step # 4: Do As Much As You Can by Phone and Skype

There is a temptation to hop on a plane to "check out the area". Don't do that unless you want to waste time and money. There is a lot of stuff you can do remotely before that time comes. For example, you can "interview" people on phone, check their references, and analyze deals, all without ever visiting them in person.

### Step # 5: Visit the Area Once You Have a Property Under Contract

Ideally, you will only visit the area once you have your first deal under contract. This gives you a really compelling reason to meet with each of your potential team members.

When you actually **do** visit the area for the first time, you should have a very specific itinerary planned.

Have your brokers give you a tour of the area, highlighting the areas that are improving and those to stay away from. Of course, visit the property you have under contract as well as any other deals you want to look at while you're there.

Meet your top picks for property managers, attorneys, lenders, appraisers, and property inspectors.

The goal of your trip is to better learn that market and finalize your team.

### Step # 6: Do a deal!

Now the team is in place and you're ready to do a deal! It may take a while to find that first deal, so make sure you keep in touch regularly with each of your team members to keep them engaged.

Once you do a deal, you'll probably have to spend some extra time at the property in the beginning to make sure the team is in place. Even though your physical presence may not be required as much, make sure you are holding everyone (especially your property manager!) accountable regularly.

## Chapter Summary

First try to invest in your own back yard unless there's a compelling reason not to. Within your own market, you need to find those areas that will produce the kind of properties and returns you're looking for. These may be in less-than-beautiful areas but they should be in the path of progress. Then within those areas we'll start looking for value-add opportunities.

If despite your best efforts you can't find deals that will meet your criteria, then you may have to look elsewhere. If you must invest out of the area, it will cost you some extra time and money, but it most certainly can be done, and we talked about how to do that.

# Chapter 3: How to Find Deals

While you will have some success with letter campaigns and getting leads from networking with other professionals, the vast majority of your deals will come from commercial real estate brokers. That's we're going to focus the bulk of our time and effort on these very important members of your team. Then we'll also talk about some other methods of getting deals, such as writing letters to apartment building owners.

## The Single Best Way to Find Deals: Commercial Real Estate Brokers

In this section I'm going to show you how to build relationships with brokers so that they take you seriously and feed you deals.

### Step # 1: Make a List of Commercial Real Estate Brokers

Here are three sources for commercial real estate brokers.

**Source # 1: Loopnet**: Go to Loopnet (www.loopnet.com) to create a list of brokers to contact. You can also find deals on Loopnet, but usually by the time a deal makes it to loopnet, it's the bottom of the barrel deal-wise. But Loopnet is a GREAT way to find potential brokers to contact.

Search for your type of building in the area you're looking in. Create a spreadsheet and make a list of each broker you find. As you go through each deal, you will find that some brokers have multiple listings. These are the BETTER brokers. In your spreadsheet, track the # of listings you find for that broker. If you click on the link for that broker, you can also see how many and what type of listings that broker has. Make a note of that also.

Then use Loopnet to send a message like the following to the broker:

*I'm looking for apartment buildings in the $1.5M to $3M range in DC, Richmond, and Baltimore. Can you please add me to your buyer's list? My email is [...]. Thanks!*

**Source # 2: CCIM.com**: Many brokers are "Certified Commercial Investment Members", and you can search for them on www.ccim.com. Add likely candidates to your list, too.

**Source # 3: Referrals**: Ask everyone you know for a referral to a good commercial real estate broker. Oftentimes, your residential real estate agents, bookkeepers, title attorneys, bankers know at least someone. Add any referral to your spreadsheet.

That should do it. You should have a list of about 15-20 brokers to contact. Time to hit the phones.

### Step # 2: Cold-Call the Broker

When you're calling the broker for the first time, you're essentially cold-calling that person.

The biggest fear of the person you're calling is that you will waste their time. You address this upfront by quickly saying why you're calling and by asking for a specific amount of time. Here's how.

***Get Up-Front Agreement Before Jumping into the main Pitch***

**You**: "Hi this is […], did I catch you at a bad time?"

If they say "yes", then ask for a better time to call back. 90% of the time, they'll say "no, go ahead", and now you have their permission to take up at least 30 seconds of their time.

**You**: "I represent a group of investors and we're interested in purchasing a $2M-$3M asset in the metro area in the next 90 days. I wanted to tell you a little more about what we're looking for and find out more about you, maybe there's a chance for us to work together. **Do you have 3-5 minutes if we stick to that timeframe?**"

What did we just do? We took 30 seconds to succinctly summarize why we're calling, we hopefully piqued the caller's interest, and we asked for a certain time frame, thereby addressing their biggest fear, which is that I'm going to keep them on the phone the rest of the afternoon. The caller figures, the worst that'll happen is that I take up 5 minutes of their time, and that'll be the end of it.

**Broker**: "Emm, sure."

**You**: "Great. What kind of properties do you usually work with?"

Does the broker specialize in apartment buildings? If so, what size and what area?

**You**: "How many different listings do you typically handle in a year?"

The more the better.

**You**: "That sounds good. Can I tell you a little more about what I'm looking for?

**Broker:** "Sure."

**You:** "I represent a group of investors looking for a 20-50 unit property in NE or SE Washington DC. I'm interested in a value play, not a re-position, but a property that has below market rents, is perhaps mismanaged, or needs some renovations. I'm most interested in a cap rate of 8% or above and after stabilization we are looking for a 10% cash on cash return. I know these are hard to find but maybe you have something we could sink our teeth into?"

**Very important**: if you reach the 5 minute mark, and you need extra time, honor your agreement and say "We're at the 5 minute mark, should we take another 3 minutes to finish the call, and then you can decide what to do next?"

This script works great because it starts out with you getting permission from the broker to spend three minutes with you on the phone upfront. Then you're accomplishing three things: (a) you're qualifying the broker. You, too, need to work with competent brokers who put together professional packages and who have good deal flow. (b) you're telling the broker what you're looking for and (c) because of using words like "reposition", "stabilize" and "cash on cash return", you are proving to the broker that you're not a bloody beginner who is likely going to waste your time.

### Step # 3: Meet the Broker in Person

If the phone call is going well, suggest to the broker that maybe you should meet for a coffee or a meal. You'd like to tell him more about you and learn more about him. Say that in your experience, this is the best way to start a good working relationship.

Most likely the broker will agree to a meeting.

Sometimes the broker will say "send me your proof of funds and we'll take it from there". At this point, you'll have to stand your ground and say something like this: "I understand that you need to qualify your buyers so that they don't waste your seller's time. In this particular case, I am syndicating the deal with a handful of investors. So the money is not actually sitting in a bank account but will be deposited into escrow before closing. How about this: why don't we get together for lunch. We'll get to know each other a bit more, and if you're not convinced we can perform, we part as friends. What do you think?"

If that doesn't work, you should politely move on to the next broker.

You should be prepared for this meeting with your Sample Deal Package that contains an overview of the kind of deal you're looking to do, more about you and your team members (attorney, property manager, banker, etc). We talked about how to do this in detail in Chapter 1 "How to Create a Sample Deal Package".

This will impress the socks off the broker and set you apart from nearly all other investors looking for properties.

The desired outcome of this meeting is that (a) the broker has a much better sense for what kind of deals you're looking for and most importantly (b) he will take you seriously and send you deals.

### Step # 4: Respond Quickly When the Broker Sends You a Deal

Once you are on a broker's buyer's list, their listings will start to appear in your inbox. It's your job to analyze the deal and quickly get back to the broker with your thoughts. If you don't, the broker will classify you as a tire kicker and either stop sending you deals or send you every deal under the sun, even if it doesn't fit your criteria.

Therefore, it's essential that you get back to the broker quickly with your analysis. For example: "This deal is not bad, it's the right size in the right area, but the asking price is way too high. The vacancies in the financials are 5% but that seems unlikely for this area. It's also missing some expenses like the insurance, landscaping and a few others. If I assume that expenses are 45% of income, and I want to get in at an 8 cap of actuals, I can't pay any more than $1.5M, but the seller is asking $1.9M. What flexibility is there in the asking price?"

This will again prove to the broker that you are serious. Over time, the broker will put you on his short list of serious buyers. And he'll also only send you deals that he thinks fit your criteria - the more you can educate the broker, the less work you have to do.

The reality is that a lot of brokers either don't have a lot of deals or won't take you seriously. Either way, they will not be sending you a lot of deals to look at. But this is OK. All you need is 3-5 good brokers who feed you good deals.

You've now identified and contacted the most critical member of your team: your trusted commercial real estate brokers. Not only will these professionals feed you deals, they will also provide you with important local knowledge (sold comps, rental comps, cap rates, city zoning changes etc). And they can also connect you with the other members of your team that you need to recruit.

## The Second Best Way to Find Deals: Send Letters to Apartment Owners

A great way to get off-market leads is to send apartment owners a letter. Just a warning: your chances of getting a deal this way are low and will take time. However, with most things in life, persistence is key. I maintained my campaign when I was looking for deals in Texas for about 6 months before I was getting enough deal flow from my network of brokers. But I got calls many months later from owners who kept the letters and decided to call me when they were interested in selling.

As the market begins to tighten and become more competitive, resorting to this strategy will become more and more important to get more reasonable deals and maybe even red-hot ones from motivated sellers who don't want to deal with a broker.

OK, let's get going with our letter campaign.

### Step # 1: Build a List of Apartment Building Owners

You can get owners' mailing addresses by accessing the public tax records. In some jurisdictions, this information is easily accessible online. In other jurisdictions, you will have to call the real estate tax assessment office and request that they create a list of mailing addresses for you.

Another way to get mailing addresses for multi-family owners is to get a realtor friend to access the tax records via their Multiple Listing Service (MLS) - this makes it really easy to search for the properties you want and export the mailing addresses in XLS format.

Calculate your marketing budget and from that determine how many letters per month you can afford to send. Let's say you want to send out 500 letters per month, and you want to send a letter to the same owner every three months. That means you need 1,500 unique mailing addresses (plus a few extra more since some letters will be undeliverable).

To get to the desired numbers of addresses (in this case 1,500), limit your search to the area(s) and size of building you're interested in. If you need to limit your search even further, pick mailing addresses of owners that live outside the area. These are absentee landlords that are often extra-motivated because they're tired of dealing with tenants, toilets, increasing repairs and maintenance and decreasing profits because they have to rely on their property managers too much.

If you need to limit the number of addresses further, search for properties that were bought 20 years ago or longer. These owners should have plenty of equity in their buildings and are more likely to agree to seller-financing or other creative terms.

At this point, you should have a spreadsheet of the owner's name, mailing address, and building address.

**Step # 2: Create and Mail the Letters**

Create a letter like the one below and do a mail-merge with that owner's particular information:

> *Dear Mr. Jones,*
>
> *I'm interested in purchasing your property at 123 50th St NE, Washington, DC.*
>
> *You won't have to pay any broker commissions. I may be able to save you thousands of dollars in taxes, and I can pay full market value for your building.*
>
> *I have to purchase a building in the next 90 days, so please call me as soon as possible at 555-555-5555.*
>
> *Thanks very much, and I look forward to hearing from you.*
>
> *Regards,*

Here's why the benefits you are highlighting are likely to pique the owner's interest:

- **You may be able to save the owner thousands of dollars in taxes.** If the owner has a good amount of equity in the building, he may be willing to seller-finance the purchase for you. For example, if the owner bought the building 15 years ago for $1M and it's now worth $3M, he has $2M of equity. If he were to sell the building outright to you, he would have to pay capital gains taxes on the $2M. Instead of that, he may want you to pay the $2M slowly over time by giving you a promissory note. This allows the seller to get a guaranteed, fixed payment while minimizing his upfront tax payment. And you wouldn't have to get a bank loan - a true win-win.

- **No commissions**. Since there is no broker involved, the owner gets to save the 5-6% he would normally have to pay to a broker.

- **Full price**: We're willing to pay full price based on actual financials as long as it meets our investment criteria.

The call-back rate is fairly low, however, so persistence is key.

> *I remember when I did a letter campaign when looking for buildings to buy in Texas. I sent out 750 letters per month and got maybe 10 calls. The key is to send a letter about every 3-6 months. Owners often keep these letters for a long time and then call you when they're thinking of selling. In fact, I got calls many months after I mailed those letters.*

## Other Ways to Find Deals

Networking is another good ways to learn about deals. Like you do when you're raising money, tell everyone you come in contact with, especially professionals like attorneys, CPAs and property managers, even residential real estate brokers, that you're in the market to buy. Every once in a while you'll get a referral to an owner who wants to sell.

## Chapter Summary

Even though there are potentially many ways to find deals, the single best way to find deals is through a network of good commercial real estate brokers. They make it their business to build relationships with apartment building owners so that when they're ready to sell, they're the first to know. Building trust with 3-5 outstanding brokers will keep you busy with good deal flow, and they'll also start feeding you off-market deals.

As the market begins to become more competitive (as it is now), sending letters directly to apartment building owners may become more necessary and productive.

# Chapter 4: How to Build an A-Team

Long before you have your first deal under contract, you should have identified these other members of your team:

- Property manager
- Landlord/tenant attorney
- Real Estate attorney
- SEC attorney
- Commercial lenders and brokers
- Property Inspector
- Appraiser
- Insurance Agent

You need to do this for every area in which you want to purchase a building. Because this is so time-intensive, it's best to concentrate on one area and buy your building(s) in that area. This requires networking and ideally face-to-face meetings, so it's best to do this in an area where you already live. As we already discussed, you can also do this outside your area - you'll just have to spend more time there, especially in the beginning.

Here's the bottom-line: Your success as an apartment building investor depends on the strength of your team. So don't cut corners and the build the best team you can.

## How to Gain Instant Credibility with Potential Team Members

When you meet with the potential team member, your goal is to pre-qualify them, of course, but you are also selling yourself. Because you typically only have an hour when you meet a person for the first time, you have to build trust quickly. The desired outcome is for both of you decide you want to move forward.

You will quickly find that your biggest challenge during this phase is being taken seriously. Here is a secret that will give you instant credibility with the professionals you're contacting.

Create a "**Credibility Package**" that includes these two documents:

- **Your Bio**: this is not a resume but a summary of your achievements. Without a track record, your goal with this one-pager is to demonstrate a track record of

**TAKE ACTION**: Create your credibility package right now - before you talk to any brokers, investors, or professionals - and long before you have your first property under contract.

**TIP**: For an example bio, take a look at mine in the Document > Raising Money from Investors > MBlank Bio.doc.

success, even if the track record is in areas outside of commercial real estate. Your message to the people you are meeting with will be that "yes, this will be my first apartment building deal, and I don't have direct experience. But I have a track record of success in other areas, and I know I'll be successful with this as well."

- **The Sample Deal Package**. We already covered this in Chapter 1 "How to Create a Sample Deal Package". Highlight the team members you've already brought on board and talk about deals you've already looked at (but didn't pursue). Also mention any financial commitments you've been able to secure.

The Sample Deal Package works like magic with brokers, professionals or investors you're trying to recruit.

## The Single Best Way To Find Your Team Members

The best way to find your team members are through **referrals**. Yes, you can search on the Internet and go to the proper association web site, but I like referrals better than any other method. In fact, you just don't want someone referring you to someone else because they've heard that that person does X or Y, you prefer referrals to people they've actually done business with.

Other apartment building owners and your commercial real estate brokers are the best source for referrals. Unfortunately, other apartment building owners may be harder to find. But if you go through the trouble, these owners can be a gold mine because they can put you in touch with their entire team - all at once.

Your brokers are an excellent source for referrals, too. Ask them for those professionals they really like and with whom they've done the most deals.

And finally, ask EVERYONE you know for a referral. Send an email to your own personal network (friends, family, co-workers), and tell them what kind of professionals you are looking for. You'll be surprised who your network can refer you to.

Try an email like this:

*Hi Frank,*

*I have a very promising 12-unit apartment building under contract in NE DC. The building is in pretty good shape and the seller is motivated to sell. The rents are below market. The plan is to make some minor renovations and replace the tenants with Section 8 tenants, which would increase the rental income substantially. I need your help in building my team. I'm looking for:*

- *Attorney # 1: familiar with structuring the LLC that will buy the building*
- *Attorney # 2: familiar with landlord tenant law in DC and who can handle evictions*
- *Property Manager: experienced with managing similar type of buildings in this area.*
- *Inspectors: to inspect the property*

- *Lenders or brokers, who have done deals recently in this area and for this kind of building.*
- *Commercial real estate broker: someone who specializes in multi-families between 10-50 units in the greater D.C. area*

*You might know someone or maybe you know of someone who may know someone -;)*

*Thanks in advance!*

As I said before, if another professional or owner has worked with the person they are referring, that carries more weight than someone who has not really worked together before.

Be very systematic about this. Create a Word document to track every referral, who referred you, and a log of any phone calls and meetings. Your goal should be to have interviewed at least five candidates for each team member position. That gives you options to pick the best but also gives you a 2nd choice in case you first pick doesn't work out. This is also why you shouldn't burn any bridges with a professional you didn't pick at first!

## Who You'll Want on Your Team

By now, you're already (hopefully) working with a handful of good commercial brokers. Here are the other team members you will need to recruit.

**Property Manager:** Aside from the broker who is finding you the deals, the property manager is the second most important member of your team. Hiring a property manager is probably the most important hiring decision you will make. The success of the project depends on the quality of your property manager. A good manager will make your life easy … a bad one … well, not so much. In fact, it's so important, that an entire chapter (Chapter 10) is dedicated to hiring and managing your property manager.

**Real Estate Attorney**: This is the attorney who will be handling your closing. You're looking for someone who has experience closing commercial real estate deals like the ones you're looking for.

**Landlord/Tenant Attorney**: This attorney will handle evictions and any other landlord/tenant disputes. Again, experience matters. Also look for fixed prices for typical evictions, monthly billing, and easy accessibility of the attorney. Often times your property manager will refer you to one they use frequently.

**SEC Attorney**: If you're going to use money from private individuals, you should strongly consider doing so with a Private Placement Memorandum (PPM) and Operating Agreement. The attorney should have experience drafting documents for commercial real estate transactions. This attorney will charge between $6,000 and $25,000, depending on the complexity and size of the transaction. The reason to consider this is to protect you from an SEC investigation if investors file a complaint because the deal has gone bad. By filing the proper disclosures (the PPM), you can sleep at night knowing that you are compliant with securities laws.

Typically you only need **one** SEC attorney, even if you're active in multiple markets. That's because most SEC attorneys can draft the necessary legal documents and file the required SEC forms nationwide.

**Commercial Lenders and Brokers**: A lender can be a direct lender (like a bank) or a broker who works with multiple direct lenders. While you can talk with national lenders, it's always good to ask for local referrals. Ask these questions:

- What kind of deals do you specialize in, and how many transactions did you close in the last year? The lender should have experience closing deals like yours.
- What is the expected down payment percentage, term (number of years), interest rate, and origination fee (points) for the type of property you're looking for?
- Once I have a deal under contract, what information do you need from me?
- Can you describe the process and how long it takes?

Once you have a deal under contract, it is a good idea to submit the package to your top 3-5 lenders to request a term sheet. That's why you should talk with at least a handful of lenders. Each lender may have slightly different requirements, and you may have to submit different documents to each lender. Working with different lenders will be time consuming, but it's worth it to get the best financing.

We'll talk a lot more about dealing with lenders and brokers in Chapter 8 "Financing the Deal".

**Property Inspector**: The inspector is important when it's time to do your due diligence. Depending on your level of experience with inspecting real estate, you can do this yourself, use your favorite general contractor, or hire a professional apartment building inspector. The expertise and cost for an inspector varies widely, so shop around.

**Insurance Agent**: This doesn't become relevant until it's time to close, and you will typically get quotes back within a few days. You will get plenty of referrals from the network you've built to this point.

**Appraiser**: You don't have control over which appraiser your lender will use. But appraisers have EXCELLENT knowledge of the local market, such as sold comps, rental comps, vacancy rates, typical expenses, cap rates, etc. They might be willing to share their knowledge with you in return for a free meal.

## Chapter Summary

In this chapter, we identified the professionals you want to recruit to your team. The one tool that will help you build credibility quickly is your Credibility Kit with your bio and Sample Deal Package.

I emphasized that referrals are the best way to find these team members, especially if they've done business with the person who referred them. A-Players like to do business with other A-Players. So ... find the A-Players!

# Chapter 5: How to Analyze the Deal with the Syndicated Deal Analyzer

## One of your Brokers sends you a deal, now what?

When a deal comes in, you will need to answer the following questions as quickly as possible:

- What is the building worth?
- What are your investment criteria and objectives?
- How would you structure the deal with the investors?
- What are the returns for you and your investors?
- How will you be paid?
- How believable are the financials reported by the seller?
- What is your version of the truth?
- What is the most you could pay for the property?

The Syndicated Deal Analyzer can answer these questions in just a few minutes. It can help you reduce your analysis from 4 hours to about 30 minutes so that you can come back with an acceptable offer price. It also generates financial projections and estimated investor returns that you can copy and paste from the spreadsheet into your Deal Package. And you can customize everything, adding and removing things as you see fit.

The Syndicated Deal Analyzer makes it easy and quick to do your first analysis. As you get into the negotiation process you can iteratively tweek the assumptions to make your projections more accurate and come up with the most competitive purchase price that still meets your criteria.

## Chapter Overview

Here's what's coming up in this chapter:

- **Key Financial Concepts Related to Commercial Real Estate Investing**: Before we get to the nuts and bolts of the Syndicated Deal Analyzer, let's first cover some basic financial concepts so we're on the same page.
- **The 10-Minute Analysis**: In this section, I'll show you how to answer the question "what is the MOST I can pay for this apartment building deal?" The Syndicated Deal Analyzer lets you do this quickly so that you're not spending hours analyzing a deal. This lets you quickly get back to the broker or seller with something like "this deal doesn't quite work for me, and here's why". As you're looking for other apartment buildings to buy, you can't afford to spend hours analyzing each deal. Even in this phase, the Syndicated Deal Analyzer incorporates different investor scenarios into the analysis.

- **Understanding Investor Returns and Structuring the Deal**: Quickly being able to incorporate your investors into the analysis is key when buying apartment buildings with private investors.
- **How to Pay Yourself**: Learn how you can pay yourself when you're syndicating an apartment building deal. Use the Syndicated Deal Analyzer to quickly see the effect of paying yourself at different points of the transaction on the financial model
- **Sharpening Your Pencil: When (and How) to Overpay**: In this video, we'll use the Syndicated Deal Analyzer to look at different scenarios side by side. Look at the numbers as reported by the seller next to "your version of the truth". For example, if the seller-reported expenses are only 30% of income, what would be the value of the building with more realistic expenses of 45%? This part of the analysis is critical when negotiating the maximum price you're willing to pay.
- **Fine Tuning the P&L**: Learn how to fine tune the projections with your particular business plan. Perhaps the vacancies and expenses are high, or rents are below market. If you could raise rents by 20% and lower expenses by 15% over the next 3 years, what impact would that have on your projections and your investors' returns? This part of the Syndicated Deal Analyzer lets you answer those questions quickly.
- **Estimating Closing Costs**. The Syndicated Deal Analyzer quickly estimates your closing costs using rules of thumbs. As you progress through due diligence, you're able to override some of these values so that your estimates become more and more accurate. Due diligence expenses and closing costs are often over-looked by real estate investors, and estimating them quickly and accurately are key for investing in apartment buildings.
- **Reviewing the Deal & Creating the Investor Deal Package**: Now it's time to put it all together! We'll review the deal as we've analyzed it so far, including what we're paying ourselves and what our investors' projected returns are. When we're all done, we'll use the Syndicated Deal Analyzer to produce a Deal Package we can give to our investors.

## Key Financial Concepts Related to Commercial Real Estate Investing

### How Much is this Building Worth? How to Determine the Value of Commercial Real Estate

Let's introduce some lingo.

In order to know the fair market value of a building, we need to know its "**cap rate"** and its "**NOI"**.

The **NOI is the Net Operating Income** and this is the income after all expenses but before debt service (i.e. the mortgage payment).

> KEY POINT: The higher the NOI, the higher the value of the property..

The **Cap Rate or "capitalization rate"** is a

multiplier that is applied to the NOI to determine the value of a building. It's like saying that the building can be valued at "ten times its Net Operating Income".

The Cap Rate is the rate of return if you were to buy the building 100% in cash. You probably wouldn't do that, but this is the standard way to measure the returns and value of a building.

Cap Rate is always such an abstract concept that an example is in order.

Imagine you have an ATM machine that makes $100,000 per year for you after all expenses (your cost to lease the space, to pay someone to maintain it for you, repairs, etc). So the NOI of this ATM machine is $100,000 per year.

You then ask a potential group of people who are interested in acquiring your ATM machine. You ask them, "what would you be willing to pay for this ATM machine?". One buyer might say "One million dollars", and you ask him how he came up with this number. He says that if he buys your ATM machine for $1M and it produces $100,000 in income, then that is a 10% cash on cash return on his money. And this sounds like an excellent investment to this investor.

Another investor ups the offer to $1.1M. The ATM finally sells for $1.2M. This would produce an 8% return to the buyer if he paid in all cash.

In mathematical terms, the Cap Rate is a ratio consisting of the NOI divided by the price (or value) of the property.

$$\text{Cap Rate} = \frac{\text{NOI}}{\text{Value}}$$

In the case of our ATM machine, the Cap Rate is 8% ($100,000 divided by $1,200,000).

If you're in the market of buying ATM machines, you could quickly compare one with another by using the cap rate. If the prevailing cap rate for ATM machines is 8%, then you can quickly calculate it's fair market value if you know its income.

Make sense?

Applying this to commercial real estate, let's say our broker brings us a deal and tells us that "Buildings in this area typically trade at an 8 cap". This means that you can use a cap rate of 8% to calculate the fair market value of a property in this area, like this:

$$\text{Value} = \frac{\text{NOI}}{\text{Cap Rate}}$$

Suppose the marketing package you get from your broker shows a Net Operating Income of $50,000. Applying an 8% cap rate, our building should be worth $625,000:

$$\text{Value} = \frac{\$\ 50{,}000}{8\%} = \$625{,}000$$

The cap rate is useful for determining the fair market value of a building because buildings in the same area tend to share a similar cap rate.

In general, the nicer the area, the higher the prices and the lower the cap rates, typically 7% and under. Conversely, properties in not-so-nice areas have lower prices and therefore have higher cap rates (10% and higher).

### Other Key Indicators

Besides the cap rate, there are three other useful indicators with which to be familiar.

#### ***Cash on cash return***

The cash on cash return is the cash flow after all expenses (including debt service) divided by the total cash invested.

$$\text{Cash on Cash Return} = \frac{\text{Cash Flow}}{\text{Total Cash}}$$

So if our annual cash flow after expenses is $20,000 and we put $200,000 into the deal, then our cash-on-cash return is 9.8%.

$$\text{Cash on Cash Return} = \frac{\$\ 20{,}000}{\$\ 200{,}000} = 10.0\%$$

Is that a good return?

Maybe, it depends on your investment criteria, which we'll discuss in the next section.

#### ***Gross Rent Multiplier***

The Gross Rent Multiplier (GRM) is similar to the cap rate in that it measures the value of a property against the income. Here is the formula:

$$\text{GRM} = \frac{\text{Price}}{\text{Rents}}$$

So, for our example:

$$\text{GRM} = \frac{\$\ 625{,}000}{\$\ 70{,}000} = 8.9$$

In the best areas, the GRM is typically around 10+, the worst areas are 7 and under, and the average is around 8.5.

You can see then, that you want to buy at the lowest GRM possible, because you're getting a better price for those same rents.

***Debt Coverage Ratio***

This is a ratio most often used by banks to determine the risk level of the building if they were to grant a loan to you. The Debt Coverage Ratio measures the ratio of net operating income to the amount of annual debt service you need to pay. Typically banks look for a Debt Coverage Ratio of at least 1.25. Here is the formula:

$$\text{Debt Coverage Ratio} = \frac{\text{NOI}}{\text{Debt Service}}$$

Assume that the Net Operating Income is $50,000 and that the annual debt service (principal and interest) is $40,000. Then the Debt Coverage Ratio is:

$$\text{Debt Coverage Ratio} = \frac{\$\ 50{,}000}{\$\ 40{,}000} = 1.3$$

Since we're above the bank's minimum debt coverage ratio of 1.25, then 1.3 looks OK.

Now we know how to value a building based on its Net Operating Income and Cap Rate, and we've introduced other key indicators such as the Cash on Cash Return, Gross Rent Multiplier and Debt Coverage Ratio.

### Determine your Deal Criteria

We've covered all of the important financial concepts and key metrics. The next step is to define your investment criteria. What cash on cash return are you looking for? What overall returns are you and your investors looking for? To achieve these kinds of returns, at what cap rate will you need to purchase the building?

Here are my investment criteria:

- Positive Cash Flow! Never get yourself into a negative cash flow situation unless you are an advanced investor.
- Cash on cash return > 10%. For example, if you put $100,000 of cash into the deal, your cash flow after debt service should be at least $10,000 per year.
- Cap Rate > 8%.
- Investor returns 10% - 15%+.
- Your minimum equity position should be 20%+. If you own less than 20% of the building, it may not be worth it for you, unless the building is really huge!

Your criteria will drive the kind of building and the area you will be looking in. The higher the returns you are seeking, the higher the cap rates will need be. If you want great properties in great areas, be prepared for lower cap rates and lower returns (but also less headaches!).

## The 10-Minute Analysis

When a deal comes in from your broker, you want to answer the question "what is the MOST I can pay for this apartment building deal and why?" in 10 minutes and get back to the broker with feedback. We won't have time to analyze the expenses and create a detailed business plan for the property. We're going to ask the broker the question "what is the prevailing cap rate in this area?" and for starters we'll calculate the fair market value of the building. In Section 2, we'll consider any possible upside we could have in this deal, but before we spend a lot more time on the deal, we want to make sure the building is at least valued fairly using reasonably conservative underwriting guidelines (which they rarely are). In Section 2, we'll consider any possible upside, but this step, let's just try to see if the seller will actually sell for a fair price on actual financials.

The Syndicated Deal Analyzer lets you do this quickly so that you're not spending hours analyzing a deal. This lets you quickly get back to the broker or seller with something like "this deal doesn't quite work for me, and here's why". As you're looking for other apartment buildings to buy, you can't afford to spend hours analyzing each deal. Even in this phase, the Syndicated Deal Analyzer incorporates different investor scenarios into the analysis.

When you get a deal from one of your brokers, they will usually supply at least a rent roll, i.e. a summary of what each unit is currently getting in rent. Or they may supply a "ProForma", which is what they **should** be getting. And maybe they'll supply some of the expenses. Here is what this could look like:

| Unit | | Rent | | Type |
|---|---|---|---|---|
| 101 | | $500 | | 1 bed/bath |
| 102 | | $498 | | 1 bed/bath |
| 103 | | $498 | | 1 bed/bath |
| 104 | Vacant | | $750 | 1 bed/bath |
| 201 | | $750 | | 1 bed/bath |
| 202 | | $524 | | 2 bed/bath |
| 203 | Vacant | $498 | | 1 bed/bath |
| 204 | | $524 | | 1 bed/bath |
| 301 | | $655 | | 2 bed/bath |
| 302 | | $750 | | 1 bed/bath |
| 303 | | $700 | | 1 bed/bath |
| 304 | | $498 | | 1 bed/bath |

** Occupancy Rate 90%

$7145.00 monthly x 9 = $64,305.00

** Beginning 5/1/2010 Building has been managed by (Owner)

Expenses

| | |
|---|---|
| JP Morgan Chase | $3,220.00 x 6 = $19,320.00 |
| WSSC (Water) | 600.00 x 6 = 3,600.00 |
| Pepco (increase rate) | 100.00 x 6 = 600.00 |
| Allied Waste | 469.00 x 6 = 2,214.00 |
| Cleaning (grass/snow/hallways) | 50.00 x 6 = 300.00 |
| 6-Month Expenses | $26,034.00 |

[** Renovations/Labor Costs 5,000.00 (Unit 104)]

Regardless of how complete the information is that is supplied, we want to be able to analyze it and get back to the broker quickly with our feedback.

Let's crack open our Syndicated Deal Analyzer and let's start in the "Summary" tab. Let's fill in the information we were provided with:

- The asking price is $530,000, and the broker is advertising the property as an "9 cap on actuals". He says this is a good deal because this is an "8-cap market" and the rents are under market.
- For the Gross Scheduled Income, take a look at the rent roll that was supplied. They reported rent of $7,145 per month, which is $85,740 per year.

So far in the Syndicated Deal Analyzer we have this (with the three things we modified highlighted):

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $515,000 | |
| Price Per Unit | $42,917 | |
| Earnest Money Depost (EMD) | $5,150 | 1% |
| Down Payment | $154,500 | 30% |
| 1st Mortgage | $360,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $39,895 | 7.7% |
| Acquisition Fee | $0 | 0.0% |
| Repairs | $0 | |
| Total Member Capital Needed to Close | $194,395 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $27,872 | |
| Cash Flow After Debt Service | $10,711 | |

## Using the 50% Rule to Estimate Expenses

If you look at the expenses that were supplied by the broker, they will look unnaturally low. That's because they are. For example, you can tell that they're missing any type of management fees.

This particular expense report is not the exception. **Most** financial reports are overly optimistic or exaggerated.

For this phase of the analysis, the initial, 10-minute analysis, we will simply ignore the expenses that were supplied and we will just use the rule of thumb that expenses are 50% of income. If the owner pays all utilities, we will use 55%.

If the expenses reported by the seller are higher than our rule of thumb, we'll use that instead.

In our example, with the 12-unit, the utilities are all paid by the tenants except water, so we will go with 50%.

The only other thing we need to check in our 10-minute analysis is the "Cap Rate at Re-Sale". By default, the Syndicated Deal Analyzer has this set at 8%, but you need to adjust this based on what you think you could sell the asset.

In our case, we will keep the 8% cap rate because from what we know, the cap rate in this area is 8%.

Now our Syndicated Deal Analyzer should look like this:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $515,000 | |
| Price Per Unit | $42,917 | |
| Earnest Money Depost (EMD) | $5,150 | 1% |
| Down Payment | $154,500 | 30% |
| 1st Mortgage | $360,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $39,895 | 7.7% |
| Acquisition Fee | $0 | 0.0% |
| Repairs | $0 | |
| Total Member Capital Needed to Close | $194,395 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $27,872 | |
| Cash Flow After Debt Service | $10,711 | |

If you scroll down a but under the "KEY INDICATORS" section, the cap rate based on the net operating income and asking price is 7.5%, already quite a bit lower than the advertised 9% cap rate by the broker. We will use this to our advantage in a bit.

Based on our adjusted expenses, what would the purchase price need to be?

Go to the top of the Summary tab and begin to reduce the purchase price until the cap rate becomes 9%. What is that purchase price?

Right, the answer is about $430,000. We would need to purchase the property for no more than $430,000 to maintain the cap rate that was advertised by the broker. Here is what we should have in the Syndicated Deal Analyzer:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $430,000 | |
| Price Per Unit | $35,833 | |
| Earnest Money Depost (EMD) | $4,300 | 1% |
| Down Payment | $129,000 | 30% |
| 1st Mortgage | $301,000 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $37,557 | 8.7% |
| Acquisition Fee | $0 | 0.0% |
| Repairs | $0 | |
| Total Member Capital Needed to Close | $166,557 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $23,272 | |
| Cash Flow After Debt Service | $15,311 | |
| **KEY INDICATORS** | | |
| Cap Rate | 8.97% | |
| Cash on Cash Return | 9.19% | |
| Debt Coverage Ratio | 1.66 | |
| Gross Rent Multiplier | 5.02 | |

Without spending a whole lot of time analyzing the financials of the deal, you can quickly get back to the broker and say, "look, you brought this deal to me because you said it was a 9-cap with some upside, and that satisfies my investment criteria. But when I look at the expenses, I noticed that they were pretty low. For example, they didn't include any kind of management fees and there was no insurance. Since the building is separately metered, which is great, based on my property manager who manages buildings like this in the same are, the expenses are normally about 50% of income for an average building. If I use that for my expenses, then to maintain a cap rate of 9%, I would need to purchase somewhere around $420,000, considerably lower than asking. But you

said it was a 9 cap and the expenses were really low. Is the seller willing to consider something like that?"

And now you were able to quickly get back to the broker with a rational explanation of why your offer price would need to be lower and you now also started the negotiation process. All by spending less than 10 minutes with the Syndicated Deal Analyzer.

## Understanding Investor Returns and Structuring the Deal

How we structure the investment with our investors depends on the size of the pie and what we want our investors' returns to be. The entire deal is driven by the investor's returns.

Before we can slice up the pie, let's first talk about your investment criteria. If you don't know what you're looking for, how will you know if you found it?

### What Should Your Investment Criteria Be for Apartment Building Investing?

Before you start investing in real estate, you have to be clear about your investment criteria. These are your "trading rules".

> *Many years ago, I spent a year or so trading options. My mentor told me that I needed to be clear about my trading rules, i.e. when I would get into a trade and when I would get out, either because of a loss or a gain. In fact, this was so important that I had to write these down before I got into a trade. I did OK with writing them down, but when greed or fear take over, it was extremely difficult to stick to them.*
>
> *My over-arching trading rule is that I need to achieve an average annual return of 12% - 15% over the life of the investment for my investors. I know at the level of returns, people will invest with me.*

**What are your trading rules for your apartment building deals?**

There are other key metrics that help you determine the returns for your investors. For example to achieve those kinds of returns (and still pay yourself something, too!) you'll need to purchase at a cap rate of about 9% or better. Even if you get into an investment at a lower cap rate (because it's distressed, for example), once you stabilize it, it better be at least a 10 cap.

Then there's the cash on cash return - also important! This determines how much cash the asset is throwing off as a percentage of the money invested. It's good to see a building throw off cash!

But some investments don't throw off a lot of cash, at least at first. Does that mean you shouldn't get into one like that? It depends.

If the building is 30% vacant with high expenses and below market rents because of mis-management, you may decide to go for it if you think you can achieve your criteria within a reasonable period of time.

At the end of the day, though, the one thing to look for more than anything else is the overall return, first and foremost for your investors, and then for yourself. Look for that 12% - 15%+ return for your investors with you owning at least 20% of the building. If you can't make that work in your financial model, and despite your best efforts you can't negotiate the price you need to make that work, you'll need to move on.

You can see that determining your maximum buy price is part science and part art.

But the first step is knowing and sticking to your trading rule. Only that way do you have an objective way of determining the most you can pay for a deal.

### How To Structure the Deal With Your Investors

Let's get back to our example. We're in the Summary tab of the Syndicated Deal Analyzer, and we're continuing our case study with the 12-unit apartment building. We're currently at a $430,000 purchase price assuming that expenses are 50% of income. The broker said that rents were on the low side, and we'll consider that in a later section.

For now, let's turn our attention to our investors. The returns for the investors will drive the deal, so let's talk about that.

Look at the section towards the bottom called "INVESTOR RETURNS". The Syndicated Deal Analyzer gives the members 70% equity by default.

Look just below that at the "Average Annual Return". That number is about 13%.

This is not bad, but we'd like to be more around 15%. Another thing is that we don't have any repairs factored into the deal yet. We'll probably need something there. According to the broker, the units could benefit from some cosmetic upgrades. Not knowing much more about this, why don't we budget $25,000 in repairs, or about $2,000 per unit. As soon as we do this, it increases the cash we need to close, which reduces the average annual return for the investors just under 10%.

In addition (or instead of) straight equity, you can also give investors a preferred rate of return, which we talked about earlier. Now it's time to see what happens to our investors' returns if we gave them a preferred rate of return.

### Incorporating a Preferred Rate of Return (PRR)

As I said before, you should only give your investors a preferred rate of return if they insist on it. Investors like a preferred rate of return for two reasons:

1. It raises their cash on cash return; and
2. It is viewed as more a guaranteed payment and therefore less risky for them. If the actual pie is smaller than projected, they will at least get a minimum return (while you get less).

The higher the PRR, the better for the investor - but the less attractive for you. Therefore you must find a balance.

With regards to the PRR, you can offer investors two choices:

**Option #1: A higher PRR but a lower equity position.**

PROS for the investor: More of a guaranteed payment, less risky.

CONS: A smaller portion of the upside if the project is more successful than anticipated.

For example, you could give your investors a higher PRR like 8% but then only give them 25% of the upside in equity.

**Option # 2: A lower PRR (or none at all) and a higher equity position.**

PROS for the investor: Higher upside potential.

CONS: Less of a guaranteed payment (or none at all).

For example, you could offer your investors a lower PRR like 5% and more equity like 50%.

What option you choose depends on:

- **How you can best achieve the returns for the investors**. Run both scenarios through the Syndicated Deal Analyzer and see which one works best for your investors (and also for you!).
- **The riskiness or potential upside of the project**. If the project has reliable cash flow, a PRR might work. But let's assume your plan is to renovate a vacant building, stabilize it and then sell it 18 months from now. This deal has very little cash flow and most of the profits are realized upon sale. So paying out a PRR makes little sense because there is no cash to distribute. If the plan is riskier but offers more upside, the investors will likely opt for a strict equity split of the profits.

**Your investors' preference**: present both options to the investor and see which they prefer. Go with the option most of your investors prefer.

### How will a Preferred Rate of Return Affect the Investors' Returns as well as My Own?

Before we set a PRR in the Syndicated Deal Analyzer, let's quickly take a look at the "Returns" tab. We want to see what **your** returns will be for a straight 70/30 split.

Look at the section "Summary of Projected Manager Cash Flows and Returns". You'll see that you are projected to receive 30% of all cash flow distributions, which are between $4,500 and $6,000 per year during the first 5 years, and you're getting about $13,500 in profits at the sale.

Let's assume you want to give your investors a 5% PRR. Adjust this in the Summary tab of the Syndicated Deal Analyzer.

This increases the investors' average annual return to just over 11%.

Now let's look at our returns in the "Returns" tab.

You'll see that our cash flow distributions dropped to between $1,700 to $3,000 per year, which is much lower because of the PRR. That's because we're paying out the first 5% of invested capital, the majority of available cash flow, to the investors.

This is an example of why a preferred rate of return is good for the investors and not so good for you, the syndicator.

Using the Syndicated Deal Analyzer you can "test" different equity and preferred rates of return structures to quickly see the effects on your investors' returns as well as your own.

## How to Pay Yourself

When you're syndicating deals, you are using other people's money but you're also doing all the work and you're creating value for your investors.

Many syndicators fail to properly compensate themselves. It's perfectly reasonable that you pay yourself for putting the deal together, managing the building to maximize cash flow, and then selling for a profit.

In the previous section, we talked about slicing the pie to achieve your investors' desired rate of return. Now let's talk about how to pay ourselves. You have an opportunity to pay yourself when you purchase the building, while you own the building, and when you dispose of it. How much you can pay yourself depends on the size of the pie.

### 1. Getting Paid When you Purchase the Building

If the deal allows it, pay yourself an acquisition fee at closing. How much? Whatever the deal allows and whatever seems reasonable to you and your investors. The broker gets paid 3% - 6% of the purchase price. Wouldn't it be reasonable to pay yourself 3% for putting the deal together?

Paying yourself an acquisition fee increases the overall cash required to close. This of course reduces your investor's returns. You need to work the acquisition fee into your projections and see if you can still achieve your desired returns for the investors.

In general, you should try to pay yourself something at closing. Shoot for 1%-3% if possible.

### 2. Getting Paid While you Own the Building

There are two ways you can pay yourself while you own the building.

The most obvious one is cash flow distributions.

The other way is to pay yourself an "asset management fee". This concept is borrowed from money managers who are paid a small percent (1-2%) of the assets they manage. You, too, could pay yourself 1% of the total cash invested. This would be paid out before the preferred rate of return distributions. This is like a preferred rate of return for you!

Again, you need to work this into your projections and see what happens to you investors' returns.

### 3. Getting Paid When you Sell the Building

When you sell the building, you need to pay closing costs and sales commissions. You need to repay the outstanding loan balance. And then you need to return the initial investment to the investors. Whatever is left over is called the "Net Proceeds from Sale".

In our example, the investors own 60% of the building, which means they get 60% of the Net Proceeds, and you get the rest. That's one way you get paid at closing.

You can also pay yourself a "Capital Transaction Fee". This would be a small amount (1% - 2%) of the sales price that would be paid to you at closing.

All of these ways you get paid must be disclosed to the investors up front and documented in the Operating Agreement and the Private Placement Memorandum (if you have one).

### Putting it all Together

Let's take a look at the effect of all of these ways of paying yourself to our 12-unit apartment building example. We will stick with the same financial projections and resale assumptions, and we will add in our fees to see what happens to the investor returns.

We're back in the Syndicated Deal Analyzer, continuing our analysis from the previous section. We ended the last section with giving the investors a 5% preferred rate of return plus 70% equity. With this structure, we're projecting about a 11% average annual return for the investors.

Let's the following compensation to the Syndicated Deal Analyzer:

- Acquisition Fee: 3%
- Asset Management Fee: 1%
- Capital Transaction Fee: 1%

Here's what we should end up with:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $430,000 | |
| Price Per Unit | $35,833 | |
| Earnest Money Depost (EMD) | $4,300 | 1% |
| Down Payment | $129,000 | 30% |
| 1st Mortgage | $301,000 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $37,557 | 8.7% |
| Acquisition Fee | $12,900 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $204,457 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $23,272 | |
| Cash Flow After Debt Service | $15,311 | |
| **KEY INDICATORS** | | |
| Cap Rate | 8.97% | |
| Cash on Cash Return | 7.49% | |
| Debt Coverage Ratio | 1.66 | |
| Gross Rent Multiplier | 5.02 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 70% | |
| Manager Equity | 30% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $12,353 | |
| Member Cash on Cash Return (Year 1) | 6.04% | |
| Average Annual Return ...................... | 8.70% | |
| IRR | 8.35% | |

All of this reduces the average annual to just under 9%, quite a bit under our target of 13% to 15%. What should we do now? We have several options:

- Pay us less of an acquisition fee.
- Negotiate a lower purchase price.

- Give up more equity to the investors.

For this example, let's assume we chose the last option, which means we'll give the investors the 5% preferred rate return plus 60% equity.

Now we're back up to around a 13% average annual return.

Let's add in a 1% Asset Management Fee. Now we're down to just under a 13% return for the investors.

Let's pay us 1% when we sell the building (the "Capital Transaction Fee"). Now we're a little lower but still above our 12% target.

Here's what your Syndicated Deal Analyzer should look like:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $575,000 | |
| Purchase Price | $430,000 | |
| Price Per Unit | $35,833 | |
| Earnest Money Depost (EMD) | $4,300 | 1% |
| Down Payment | $129,000 | 30% |
| 1st Mortgage | $301,000 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $37,557 | 8.7% |
| Acquisition Fee | $12,900 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $204,457 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $34,725 | 45% |
| Net Operating Income | $42,441 | |
| Debt Service | $23,272 | |
| Cash Flow After Debt Service | $19,169 | |
| **KEY INDICATORS** | | |
| Cap Rate | 9.87% | |
| Cash on Cash Return | 9.38% | |
| Debt Coverage Ratio | 1.82 | |
| Gross Rent Multiplier | 5.02 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 60% | |
| Manager Equity | 40% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $14,364 | |
| Member Cash on Cash Return (Year 1) | 7.03% | |
| Average Annual Return ...................... | 12.32% | |
| IRR | 11.32% | |

See how that works?

### Keep your Investors in Mind

Regardless of how you decide to pay yourself, make sure you disclose how you're compensated to the investors up front. This is usually done in the LLC operating agreement and/or the Private Placement Memorandum (if you have one).

Also make sure that your compensation is reasonable and that your investors achieve their projected rates of return. If you are the only one being paid and the investors are not, it will leave a sour taste in their mouths and they're not likely to invest with you again.

You are providing real value to your investors and are doing all the work, so don't be afraid to compensate yourself reasonably when you buy the building, while you own it, and when you dispose of it.

## Sharpening Your Pencil: When (and How) to Overpay

When you get a deal in from your broker, the marketing package usually provides actual financials as well as "pro forma" financials, i.e. the way the building **should** perform if it were managed perfectly. Most often, the asking price is based on the pro-forma net operating income at the prevailing cap rate for that market.

This is why the asking price for 99% of deals is always too high.

As we discussed previously, your job is to figure out the most you would pay for a building and do so in the shortest possible time.

The way to do this in the Syndicated Deal Analyzer is to compare three scenarios side by side:

- Column # 1: The actual financials as reported by the broker or seller;
- Column # 2: My version of the truth; and
- Column # 3: Projected: How the building is likely to perform a year or so after I purchase it.
- Column # 4: Offer: Contains the numbers that I will use to ultimately underwrite the deal.

In this section, we will use the Syndicated Deal Analyzer to determine the maximum purchase price by comparing these three scenarios side by side.

### Application # 1: Comparing Reported Financials to Your Version of the Truth

If you want to get more detailed about comparing the financials supplied by the seller with "your version of the truth", it helps to see these two scenarios side by side. So let's head to the "Scenarios" tab and do just that so that we can use it to continue to negotiate the deal.

In the first column ("Reported") add the numbers supplied by the seller or listing broker. Add the asking price of $515,000 to the top. This column is meant to represent how the broker underwrote the deal in his marketing package. I.e. Use the asking price and provided financials and cap rate in this column. For the purpose of this exercise, assume the expenses are as provided below, so that we end up with the following in the Scenarios tab:

| Acquisition Cost | Seller Disclosed |
|---|---|
| Price | $515,000 |
| # Units | 12 |
| Price Per Unit | $42,917 |
| Downpayment % | 30% |
| Downpayment $ | $154,500 |
| Loan Balance | $360,500 |
| Estimated repairs | $0 |
| Estimated closing costs 2.5% | $12,875 |
| Total Member Capital Needed to Close | $167,375 |
| **Total Acquisition Cost** | **$527,875** |

| INCOME | Reported | |
|---|---|---|
| Gross Potential Income | **$85,740** | |
| - Vacancy | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% |
| Effective Gross Income | $77,166 | |
| Other Income | $0 | |
| **Total Gross Income** | **$77,166** | |

| EXPENSES | Reported | |
|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% |
| Insurance | $5,100 | 6.61% |
| Water and Sewer | $7,200 | 9.33% |
| Electric | $1,200 | 1.56% |
| Gas | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% |
| Management Fees | $0 | 0.00% |
| Legal Fees | $0 | 0.00% |
| Contract Services | $600 | 0.78% |
| Repairs and Maintenance | $10,900 | 14.13% |
| General/Admin | $0 | 0.00% |
| Payroll | $0 | 0.00% |
| Other | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | $0 |
| **Total Expenses (Added)** | **$33,928** | **43.97%** |
| **Total Expenses (Manual Override)** | $33,928 | 43.97% |
| **Total Expenses** | **$33,928** | |
| | | |
| **Net Operating Income (NOI)** | **$43,238** | |

| Summary | Reported |
|---|---|
| Debt Service (6%/25Yrs) | $27,872 |
| Cash flow after debt service | $15,366 |
| Cap Rate (NOI/Sales Price) | 8.40% |
| Cash on Cash Return | 9.18% |
| Debt Coverage Ratio | 1.55 |

We can see, for example, that there are no management fees missing. This probably also explains why our underwriting of the broker's deal only yields a cap rate of 8.4% versus his advertised 9 cap deal.

Let's see what else might be missing and correct that in column # 2 "Our Version":

- **Take a look at the rental income**. Are the rents reported **actuals** or pro-formas (i.e. market level rents). If they're market-level rents, then override the rental income in column # 2 with actual rents. In our case, the reported rents look good enough, so we'll keep them the same in column # 2.
- **What about the vacancy rate?** The seller's financials often say "fully occupied" or 5%. Unless you have better information to the contrary, use a vacancy rate of 10% in column # 2. We will keep the 10% vacancy in column 2.
- **If the expenses are below 50%, then use 50% in column # 2**. Ignore all of the detailed, item-by-item expenses, just override the row labeled "Total Expenses (Manual Override). The reported financials are only 36% of income (we can quickly see that they don't contain any management fees, for example), but we will ignore these itemized expenses and override this with the 45% rule.

Based on this analysis, we will keep column # 2 the same as column # 1 **EXCEPT** for the expenses, which we adjusted to 50%. Here's is what we should have:

| Acquisition Cost | Seller Disclosed | My Version |
|---|---|---|
| Price | $515,000 | $430,000 |
| # Units | 12 | 12 |
| Price Per Unit | $42,917 | $35,833 |
| Downpayment % | 30% | 30% |
| Downpayment $ | $154,500 | $129,000 |
| Loan Balance | $360,500 | $301,000 |
| Estimated repairs | $0 | $25,000 |
| Estimated closing costs 2.5% | $12,875 | $10,750 |
| Total Member Capital Needed to Close | $167,375 | $164,750 |
| **Total Acquisition Cost** | **$527,875** | **$465,750** |

| INCOME | Reported | | My Version | |
|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $85,740 | |
| - Vacancy | ($8,574) | 10.00% | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $77,166 | |
| Other Income | $0 | | $0 | |
| **Total Gross Income** | **$77,166** | | **$77,166** | |

| EXPENSES | Reported | | My Version | |
|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $0 | 0.00% |
| Insurance | $5,100 | 6.61% | $0 | 0.00% |
| Water and Sewer | $7,200 | 9.33% | $0 | 0.00% |
| Electric | $1,200 | 1.56% | $0 | 0.00% |
| Gas | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $0 | 0.00% |
| Management Fees | $0 | 0.00% | $0 | 7.00% |
| Legal Fees | $0 | 0.00% | $0 | 0.00% |
| Contract Services | $600 | 0.78% | $0 | 0.00% |
| Repairs and Maintenance | $10,900 | 14.13% | $0 | 0.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | $0 | $0 | $0 |
| **Total Expenses (Added)** | **$33,928** | **43.97%** | **$0** | **0.00%** |
| **Total Expenses (Manual Override)** | $33,928 | 43.97% | $38,583 | 50.00% |
| **Total Expenses** | **$33,928** | | **$38,583** | |
| | | | | |
| **Net Operating Income (NOI)** | **$43,238** | | **$38,583** | |

| Summary | Reported | My Version |
|---|---|---|
| Debt Service (6%/25Yrs) | $27,872 | $25,529 |
| Cash flow after debt service | $15,366 | $13,054 |
| Cap Rate (NOI/Sales Price) | 8.40% | 8.97% |
| Cash on Cash Return | 9.18% | 7.92% |
| Debt Coverage Ratio | 1.55 | 1.51 |

Remember, the listing agent was advertising this as a 9-cap deal on actual financials. But after adjusting the "actual" financials from the reported 44% to our 50%, the net operating income, of course, is lower, and therefore the value of the building.

This is why we dropped the price to $430,000 in our 10-Minute Analysis because that was the price based on a 9-cap and our adjusted financials.

Therefore, the methodology here is to reduce the purchase price until the cap rate matches what was advertised in the marketing package (or until it matches what you want!).

So Application # 1 of the Scenarios tab is to "adjust" the broker's underwriting with yours and testing flexibility on the price based on this adjustment.

> *I often use the Scenarios tab for my 10-minute analysis (instead of the Summary tab) because I can quickly see the broker's underwriting next to mine and that helps me guide the conversation. And then what I do, each time I revise the underwriting, I update the Summary tab which then feeds the model.*

### Application # 2: How Much Should You Overpay for a Value-Added Deal?

Let's suppose that you're looking at a value-add deal. Maybe the rents are low or the vacancies are high, perhaps of mismanagement or other type of distress.

You believe that within 1-2 years you could add significant value by stabilizing the asset.

Now, if you know that, other potential buyers of the building are going to know that, and if you insist on paying fair market value on actual financials, you're never going to be competitive.

So you're going to have to overpay.

That's right. Overpay.

Now hear me out before you shout and scream that this is not what's taught in apartment building investing school.

It is true that you should value a building based on its **actual** net operating income. But sometimes, especially if it's a value-added deal, you may have to over pay slightly to be more competitive and get the deal.

But how much to over pay, that is the question!

Using side-by-side scenarios helps you answer this question.

Back to our 12-unit example. If you examine the rent roll supplied by the buyer, you'll notice that the seller is getting an average of $550 for the 1 bedrooms.

You do a quick rent analysis using rentometer.com and Craigslist, and you notice that one bedrooms are actually renting for around $775. Section 8 subsidized housing even pays $844!

You know that the value-add part of this deal is raising rents to market level.

You use column # 3 to enter your projected financials. You want to see what the cap rate, cash on cash return, etc would be once you've stabilized or otherwise optimized the asset.

So, in column # 3, under income, you're going to enter in the projected income. Let's assume that number is $108,000 (an average of $750 per unit). Assuming expenses stay at 50% (they'll probably be lower), then the net operating income will be $48,600.

Let's say we really want to buy the asset for at least a 9 cap on actuals. The "actuals" are in column # 2, which is "our version of the truth". We would need to buy it for $430,000, but the asking price is $515,000. That doesn't make us very competitive. How competitive could we be?

To answer this question, we play with the purchase price in column # 3 "Projected". We could raise the price all the way to $540,000 and that would be at a 9 cap on **projected** financials.

Well, we're not going to credit the seller with **that** much of my upside. You might pay a little extra to get into the deal, but if you're going to work your tail off to create value, then the majority of the upside should be yours. But how much?

You might say to yourself that you would over pay by up to 25% of the difference. Here's what I mean:

Column 2: At $430,000 the cap rate is 9% on **actuals**.

Column 3: At $540,000, the cap rate is 9% on **projections**.

The difference between the two prices is $110,000.

25% of that is $27,500, which would be your maximum allowable premium for the purpose of this exercise. How did you come up with this premium? The answer is somewhat subjective. Conceptually you don't want to give the seller **half** of your potential upside. But in order to be more competitive in your offer price, perhaps you can give them a little credit. That's how you came up with the 25% maximum allowable premium.

Anyway, if you add this "premium" of about $27,500 to the $430,000 base price then your maximum allowable purchase price is $430,000 + $27,500 = $457,500. So let's say $460,000 for round numbers. This is now the most you're willing to pay.

Let's shift our attention to column # 4 which is labeled "Offer". This column is used to determine the numbers with which you plan to underwrite this deal along with your maximum purchase price.

Complete the "Offer" column (column # 4) with the income and expenses from the "My Version" column and the purchase price of the "Projected" column ($460,000). Here is now the entire "Scenarios" tab completed:

| EXPENSES | Reported | | My Version | | Projected | | Offer | |
|---|---|---|---|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Insurance | $5,100 | 6.61% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Water and Sewer | $7,200 | 9.33% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Electric | $1,200 | 1.56% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Gas | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Management Fees | $0 | 0.00% | $0 | 7.00% | $0 | 7.00% | $0 | 7.00% |
| Legal Fees | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Contract Services | $600 | 0.78% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Repairs and Maintenance | $10,900 | 14.13% | $0 | 0.00% | $0 | 10.00% | $0 | 10.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $0 |
| **Total Expenses (Added)** | **$33,928** | **43.97%** | **$0** | **0.00%** | **$0** | **0.00%** | **$0** | **0.00%** |
| **Total Expenses (Manual Override)** | $33,928 | 43.97% | $38,583 | **50.00%** | $48,600 | **50.00%** | $38,583 | **50.00%** |
| **Total Expenses** | **$33,928** | | **$38,583** | | **$48,600** | | **$38,583** | |
| | | | | | | | | |
| **Net Operating Income (NOI)** | **$43,238** | | **$38,583** | | **$48,600** | | **$38,583** | |

| Summary | Reported | My Version | Projected | Offer |
|---|---|---|---|---|
| Debt Service (6%/25Yrs) | $27,872 | $25,529 | $32,060 | $27,310 |
| Cash flow after debt service | $15,366 | $13,054 | $16,540 | $11,273 |
| Cap Rate (NOI/Sales Price) | 8.40% | 8.97% | 9.00% | 8.39% |
| Cash on Cash Return | 9.18% | 9.34% | 9.57% | 7.58% |
| Debt Coverage Ratio | 1.55 | 1.51 | 1.52 | 1.41 |

If you purchase at $460,000, then you're going in at a cap rate of 8.4%. While this is below your target of 9%, you have not yet fully integrated the projected upside into the projections of this deal, and you have not yet considered the investor returns. We'll do both in the next section.

Before we end this Section, let's be sure to update the Purchase Price in the Summary Tab with our new price of $460,000:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $460,000 | |
| Price Per Unit | $38,333 | |
| Earnest Money Depost (EMD) | $4,600 | 1% |
| Down Payment | $138,000 | 30% |
| 1st Mortgage | $322,000 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,382 | 8.3% |
| Acquisition Fee | $13,800 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $215,182 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $24,896 | |
| Cash Flow After Debt Service | $13,687 | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $24,896 | |
| Cash Flow After Debt Service | $13,687 | |
| **KEY INDICATORS** | | |
| Cap Rate | 8.39% | |
| Cash on Cash Return | 6.36% | |
| Debt Coverage Ratio | 1.55 | |
| Gross Rent Multiplier | 5.37 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 70% | |
| Manager Equity | 30% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $11,302 | |
| Member Cash on Cash Return (Year 1) | 5.25% | |
| Average Annual Return ...................... | 6.21% | |
| IRR | 6.14% | |

The returns are down to a paltry 6.2%. But we haven't incorporated the upside potential into the projections, which is what we'll do in the next section.

**Conclusion**

The purpose of the Side-by-Side scenario is to give you a worksheet to quickly see different scenarios side by side. It can be used to point out flaws with the seller's underwriting as well as consider how much of the upside you should price in.

Now that we've adjusted our potential purchase price to $460,000, it's time to fine-tune the financial projections and assess the investor returns.

## Fine Tuning the P&L

In this section we want to incorporate our business plan into the projections. In our example, that business plan is increasing the rents over the next three years.

Now we're going to turn our attention to the detailed 10 year profit and loss projection in the "P&L" tab. The P&L in the Syndicated Deal Analyzer uses a default of a 3% per year increase in rents and expenses. For a stabilized asset, this is a pretty asssumption.

But in many cases, and certainly in the kind of deals I'm looking for, I'm looking to add value. This means that the income should increase substantially more than 3% each year.

Therefore, you will need to override the defaults in the P&L to more accurately model the particular business plan for your deal.

Perhaps the vacancies and expenses are high, or rents are below market. If you could raise rents by 20% and lower expenses by 15% over the next 3 years, what impact would that have on your projections and your investors' returns? This part of the Syndicated Deal Analyzer lets you answer those questions quickly.

Let's get started.

OK, let's take a look at the first column of the P&L tab of the Syndicated Deal Analyzer. You see that many of the numbers are blue. If you look at the formulas, you'll see that it takes the values from the Summary tab by default.

| FINANCIAL ASSUMPTIONS | Year 1 | | Year 2 | |
|---|---|---|---|---|
| Annual Rent Escalator | 3.00% | | 3.00% | |
| Annual Expense Escalator | 3.00% | | 3.00% | |
| **INCOME** | **1** | | **2** | |
| Gross Potential Income | $85,740 | | $88,312 | |
| - Vacancy | ($8,574) | 10.00% | ($8,831) | 10.00% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $79,481 | |
| Other Income | $0 | | $0 | |
| **Total Net Income** | **$77,166** | | **$79,481** | |
| **EXPENSES** | | | | |
| Real Estate Taxes | $0 | 0.00% | $0 | 0.00% |
| Insurance | $0 | 0.00% | $0 | 0.00% |
| Contract Services | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $0 | 0.00% | $0 | 0.00% |
| Electric | $0 | 0.00% | $0 | 0.00% |
| Gas | $0 | | | |
| Water and Sewer | $0 | | | |
| Legal | $0 | 0.00% | $0 | 0.00% |
| Management Fee 7.00% | $0 | 7.00% | $5,564 | 7.00% |
| Repairs and Maintenance | $0 | 0.00% | $0 | 0.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% |
| Deposit to Replacement Reserve | $0 | 0.00% | $0 | 0.00% |
| **Total Expenses** | **$38,583** | **50.00%** | **$39,740** | **50.00%** |
| **Net Operating Income (NOI)** | **$38,583** | | **$39,740** | |

You can override any number in blue, and that will update the entire financial model.

Back to our example: let's assume we think that it will take us 3 years to raise rents to market-level. This means that in Year 1, gross rents would be $85,740 (as they currently are, an average of $595 per unit) and Year 3 they would be $108,000 ($750 per unit). For Year 2, you could split the difference and make the gross rents $95,000. In Year 4 and after, the 3% defaults would apply.

If we make these adjustments, we get the following P&L tab:

| INCOME | 1 | | 2 | | 3 | | 4 |
|---|---|---|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $95,000 | | $108,000 | | $111,240 |
| - Vacancy | ($8,574) | 10.00% | ($9,500) | 10.00% | [illegible] | 10.00% | ($11,124) |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Effective Gross Income | $77,166 | | $85,500 | | $97,200 | | $100,116 |
| Other Income | $0 | | $0 | | $0 | | $0 |
| **Total Net Income** | **$77,166** | | **$85,500** | | **$97,200** | | **$100,116** |
| | | | | | | | |
| **EXPENSES** | | | | | | | |
| Real Estate Taxes | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Insurance | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Contract Services | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Trash Removal | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Electric | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Gas | $0 | | | | | | |
| Water and Sewer | $0 | | | | | | |
| Legal | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Management Fee 7.00% | $0 | 7.00% | $5,985 | 7.00% | $6,804 | 7.00% | $7,008 |
| Repairs and Maintenance | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| General/Admin | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Payroll | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Other | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| Deposit to Replacement Reserve | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 |
| **Total Expenses** | **$38,583** | **50.00%** | **$39,740** | **46.48%** | **$40,933** | **42.11%** | **$42,161** |
| | | | | | | | |
| **Net Operating Income (NOI)** | **$38,583** | | **$45,760** | | **$56,267** | | **$57,955** |

After manually overriding the defaults in the P&L tab, let's see what that did to our investors' average annual returns. Go back to the Summary tab and scroll down.

Whoa!

The average annual return for our investors is suddenly at over 21.57% !!!

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $460,000 | |
| Price Per Unit | $38,333 | |
| Earnest Money Depost (EMD) | $4,600 | 1% |
| Down Payment | $138,000 | 30% |
| 1st Mortgage | $322,000 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,382 | 8.3% |
| Acquisition Fee | $13,800 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $215,182 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $24,896 | |
| Cash Flow After Debt Service | $13,687 | |
| **KEY INDICATORS** | | |
| Cap Rate | 8.39% | |
| Cash on Cash Return | 6.36% | |
| Debt Coverage Ratio | 1.55 | |
| Gross Rent Multiplier | 5.37 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 70% | |
| Manager Equity | 30% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $11,302 | |
| Member Cash on Cash Return (Year 1) | 5.25% | |
| Average Annual Return ...................... | 21.57% | |
| IRR | 17.45% | |

Why is that? That's because the income in the first three years increased substantially, increasing the net operating income and therefore the value.

Our business plan to add value now increased the returns to over 21% for the investors, but our target is around 15%. What can we do with this?

We could do one or more things, such as:

- We could increase our purchase price to be more competitive;
- We could give less equity to the investors;
- We could pay ourselves more; for example, we could introduce an asset management fee and/or capital transaction fee when we sell; and/or
- We could build in a larger margin for error by increasing the capital reserves for renovations or emergencies.

Based on the updated P&L, how should we adjust our deal then?

For the purpose of this exercise, let's reduce some of the investor's equity from 70% to 50% and increase our purchase price to $485,000 to be more competitive. This gives us about a 15% average annual return for the investors, which is what we're looking for. This would mean that we would be buying the building at an 8 cap on actual financials and expenses of 50%, which is a fair market deal but with substantial upside. And, most importantly, we're achieving our investors' returns. Now we have:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $485,000 | |
| Price Per Unit | $40,417 | |
| Earnest Money Depost (EMD) | $4,850 | 1% |
| Down Payment | $145,500 | 30% |
| 1st Mortgage | $339,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $39,070 | 8.1% |
| Acquisition Fee | $14,550 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $224,120 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $26,249 | |
| Cash Flow After Debt Service | $12,334 | |
| **KEY INDICATORS** | | |
| Cap Rate | 7.96% | |
| Cash on Cash Return | 5.50% | |
| Debt Coverage Ratio | 1.47 | |
| Gross Rent Multiplier | 5.66 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 50% | |
| Manager Equity | 50% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $11,206 | |
| Member Cash on Cash Return (Year 1) | 5.00% | |
| Average Annual Return ........................ | 14.89% | |
| IRR | 12.97% | |

The point is, you can adjust various parts of the model and immediately see the impact on your investor's average annual return, which is driving the entire deal.

## Estimating Due Diligence and Closing Costs

The Syndicated Deal Analyzer quickly estimates your closing costs using rules of thumbs. As you progress through due diligence, you're able to override some of these values so that your estimates become more and more accurate. Due diligence expenses and closing costs are often over-looked by real estate investors, and estimating them quickly and accurately are key for investing in apartment buildings.

Let's turn to the "Acquisitions Cost" of the Syndicated Deal Analyzer.

This tab uses rules of thumb to estimate your due diligence costs and acquisition costs. The items with the asterisk to the right are expenses that are normally payable **before** closing, which means that those expenses are "at risk" costs that you don't get back if you don't close. Those out-of-pocket, at-risk expenses are:

- Legal fees to draft PPM and operating agreements for closing;
- Property and/or lead-paint inspections;
- Appraisal fee and 3rd party reports required by the bank.

| Cash Requirements at Closing / Members Capital | $220,545 |
|---|---|
| **Closing Costs and Reimbursable Expenses** | |
| Legal Fees (LLC, PPM)* | $11,500 |
| Propery Inspection ($250/unit)* | $3,000 |
| Lead Paint Inspection ($200/unit)* | $2,400 |
| Lender Fees and 3rd Party Reports | |
| EDR (Environmental) | $800 |
| Appraisal* | $3,000 |
| Structural Inspection | $800 |
| Bank Legal Fees | $2,000 |
| Bank Doc Prep Fee | $350 |
| Origination Fee (1%) | $3,325 |
| Total Lender Fees and Reports | $10,275 |
| Closing Costs | |
| Title Policy (0.6%) | $2,850 |
| Survey | $600 |
| Recording | $207 |
| Transfer Taxes (1.45%) | $6,888 |
| Title Processing Fee | $500 |
| Title Search | $275 |
| Other | $300 |
| Total Closing Costs | $11,620 |
| Total Closing and Other Costs | $38,795 |
| * Typically Payable Before Closing | |

As we'll discuss later when we talk about doing due diligence, our goal will be to delay those expenses as much as possible to increase the probability of closing so that we get reimbursed for those fees.

**Take my rules of thumb with a grain of salt!**

While these estimated closing and due diligence costs are based on actual transactions and research, they **will** be different for your area and for your deal.

The first thing you should do as you start looking for properties is to modify these estimates for your area. Talk to your lender to get guidance what the bank-related fees will be. The rest of the fees you can get from your title company. Have them send you a fictitious HUD-1 based on your expected purchase price. If you're not going to create a PPM or order lead-paint or property inspections, then remove those expenses.

If you spend a little extra time upfront, then it will make your acquisition costs more accurate and therefore the entire model.

Do this now.

## Reviewing the Deal & Creating the Investor Deal Package

Now it's time to put it all together! We'll review the deal as we've analyzed it so far, including what we're paying ourselves and what our investors' projected returns are. When we're all done, we'll use the Syndicated Deal Analyzer to produce a Deal Package we can give to our investors.

Here is what we know so far about our deal, the assumptions we're making, and how we chose to underwrite the deal:

- The seller is asking $515,000. She is reporting $7,145 per month (or $85,740) of gross rental income and a 10% vacancy rate. Let's use those figures for now.
- Our version of the true expenses is 50% of income.
- Based on our initial property tour, we estimate we'll need $25,000 in mostly cosmetic repairs.
- We think we will have to put 30% down and finance the rest with a 25-year bank loan at an interest rate of 6.0%.
- We are paying ourselves a 3% acquisition fee, a 1% management fee, and a 1% disposition fee.
- Investors get a 5% preferred rate of return and 50% of equity in the building.
- The Cap Rates in this area (for estimating the re-sale value in five years) is 8%.
- We updated the 5 year P&L and are confident we can raise rents to market in 3 years, from gross income of $85,000 currently to $108,000 in 3 years.

- In order to achieve an average annual return for the investors of about 15%, we decided the most we can pay is $485,000.

We enter all of this information into the "Summary" tab so that we get the following:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $485,000 | |
| Price Per Unit | $40,417 | |
| Earnest Money Depost (EMD) | $4,850 | 1% |
| Down Payment | $145,500 | 30% |
| 1st Mortgage | $339,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $39,070 | 8.1% |
| Acquisition Fee | $14,550 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $224,120 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $38,583 | 50% |
| Net Operating Income | $38,583 | |
| Debt Service | $26,249 | |
| Cash Flow After Debt Service | $12,334 | |
| **KEY INDICATORS** | | |
| Cap Rate | 7.96% | |
| Cash on Cash Return | 5.50% | |
| Debt Coverage Ratio | 1.47 | |
| Gross Rent Multiplier | 5.66 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 50% | |
| Manager Equity | 50% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $11,206 | |
| Member Cash on Cash Return (Year 1) | 5.00% | |
| Average Annual Return ........................ | 14.89% | |
| IRR | 12.97% | |

Now that we know the most we can pay is $485,000, we must now negotiate the deal and make sure we don't pay any more than $485,000. So, perhaps we make an offer at $450,000 to give us some room to negotiate.

### Creating the Deal Package

We'll spend a whole chapter on negotiation tips and making offers. So for the purposes of this exercise and to finish off this chapter on analyzing the deal, let's assume you end up putting this building under contract for $530,000.

Once we have the Syndicated Deal Analyzer complete the way we want it, it's time to create the Deal Package for our investors and commercial lenders.

Take a look at the Deal Package in the Document Library > Raising Money from Investors > Sample Deal Package-New Hampshire.doc.

Edit the text in the Sample Deal Package to fit your deal and copy and paste the appropriate sections from the Syndicated Deal Analyzer into the Deal Package. To make it easy to copy sections from the Syndicated Deal Analyzer, I use a free program called "Jing" to copy specific portions of a document or screen. Google "download techsmith jing" to download this free application and watch the short "getting started" video.

## Chapter Summary

We covered a lot in this chapter about analyzing deals. But it's so important because you'll spend most of your time in this stage because finding good deals can be like finding a needle in a hay stack sometimes. You may have to analyze many deals to find a good one.

Here's what we covered in this section:

- Key Financial Concepts Related to Commercial Real Estate Investing
- The 10-Minute Analysis
- Understanding Investor Returns and Structuring the Deal
- How to Pay Yourself
- Sharpening Your Pencil: When (and How) to Overpay
- Fine Tuning the P&L
- Estimating Closing Costs
- Reviewing the Deal & Creating the Investor Deal Package

Now that we know how to analyze deals quickly and efficiently, and we've determined our maximum allowable purchase price, it's time to negotiate!

# Chapter 6: Make and Negotiate Offers That Get Accepted

## It's all About the Numbers

Making and negotiating offers is all about the numbers. Yes, you can use clever phrases and find the 3rd level of the seller's pain to push the right buttons, but at the end of the day, numbers are what drives the deal.

Doing the proper analysis like we've done answers the most important question, "what is the most I can pay?" Without this knowledge, how do you know when to walk away? This is absolutely critical.

Another reason the numbers are important is that it lets you be consistent and "reasonable" with your negotiating.

When someone tells me, "the building was appraised for $1.1M and that's what I want for it!" you can share with the seller your analysis and how you've arrived at your offer price. You counter emotion with rationality. I've found that this approach results in agreement more often than not.

**Here's what we're going to cover in this Chapter:**

- 10 Negotiation tips to get your offers accepted
- Effectively negotiating in writing via a broker
- Getting the ball rolling with informal emails and phone calls
- Submitting a short but to-the-point Letter of Intent
- Purchase Contracts that keep you in control.
- How to amend purchase contracts with addenda.

## 10 Negotiation Tips to Get Your Offers Accepted

Here are 10 techniques to substantially improve the outcome of your negotiations.

### Tip # 1: Agree on Methodology

Before talking price, get agreement on how you will arrive at the price. You could say something like, "Buildings like yours are selling at a cap rate of 8% based on actual financials. And you would agree that buying a building on actual financials is critical, or would you disagree?"

You are trying to get agreement on the process for determining fair market value of the building. If the seller agrees to this, you can use it later on during your discussion about price. "I know you said you wanted $1.1M but we also agreed earlier that the value is around an 8 cap of actual financials. If we use that methodology, your building is really worth only $900K. And this doesn't include the deferred maintenance we discussed

during the walk through. But maybe I'm missing something. Maybe you can walk me through how you're arriving at your asking price?"

If the seller agrees on the methodology, he is more likely to agree on the result: the price and terms.

This also helps you later on during due diligence. Let's say you discover that 20% of the tenants are not paying the rent. This information obviously changes the deal. You can now go back to the seller and say, "your Net Operating Income is now $10,000 lower per year than we thought at first. Based on the 8% cap rate we've been using, this reduces the offer price by $125,000." The seller may not like this but he can't argue with your reasoning!

Again, the more you can explain HOW you've arrived at a number, the more effective you will be in getting offers accepted.

### Tip # 2: Be a Reluctant Buyer

Don't seem too eager to get a deal done. You can use some of these techniques to seem more like a reluctant buyer.

#### *Play the "What If" Game*

Price certainly is a major consideration, but there are others, too, like seller financing or assuming the existing mortgage. I try to explore different things the seller would and would not consider. "If I did this, would you consider that?" or "What if we did that, would you consider that or probably not?"

This is a great, non-threatening way to explore different options.

Would the seller consider some seller financing? This would reduce the amount of money you'd have to raise. If not, maybe she would consider it if you paid a slightly higher price? Would she consider a lower price if you pay a larger deposit?

"Hypothetically, if we could come up to $1.3M, would you consider holding back some seller financing for a short period of time?"

#### *Don't be so Sure*

An extension of the "What If" game is not being sure something will work for you.

"Hypothetically, if we could come up to $1.3M, <u>and I'm not sure that's going to work, but let's say it does</u>. Would you consider holding back some seller financing for a short period of time?"

### Tip # 3: Refer to a Higher Power

From the very beginning, let the seller (and his broker) know that you have a partner - whether you actually do or not - it doesn't matter. While you can make some decisions in a negotiation, for the major ones say, "that sounds reasonable to me, but let me check with my partner." You may want to think about a proposal a bit more, or you might have to run some numbers or do some more due diligence. It also gives you a way to counter

a seller's proposal later by saying, "I thought your proposal was reasonable, but my partner didn't agree, he said we need a price of $1.25M to make it work for him."

Here's an example of how you could extend the previous dialog by referring to a partner:

"Hypothetically, if we could come up to $1.3M, and I'm not sure that's going to work for my partner, but let's say it does. Would you consider holding back some seller financing for a short period of time?"

If the seller sees through your negotiating tactic and requests to speak with your elusive partner, you can say something like, "that won't be possible I'm afraid. He's a very successful business man and travels a lot. He wants me to do the legwork, and he trusts me, but he also controls the funds. I think we can make it work. What's next for us to discuss?"

On the other hand, if your seller is using this technique on you, you need to try to involve the seller's partner in the conversation. Otherwise, each time you and the seller agree on something (or you think you agreed on something), the seller will come back with some counter offer. This is not only aggravating but puts you at a disadvantage. Try to get this partner involved in the next meeting or phone call.

### Tip # 4: Visit the Property

It helps to visit the property for at least two reasons: (1) it might give you a chance to meet the seller in person and (2) you can get a sense of what repairs and improvements will need to be made.

Having a sense for what repairs and improvements you want to make are key to the negotiation process. If the property needs a new roof, boiler and parking lot (all deferred maintenance), you can make a strong case for a lower purchase price compared to other similar properties sold.

### Tip # 5: Get Up-Front Agreement Before Meetings

Before an in-person meeting with a broker and seller, always get agreement on the time you have together and the agenda. The worst that could happen is that you small talk for 20 minutes and the other person only has 30 minutes available.

Start off with something like this:

**You**: "What I wanted to do today is to brainstorm a bit, to see what we would both consider and not consider. If by the end of lunch we don't think it makes sense, we'll part as friends, otherwise we'll talk about next steps. Does that sound like a reasonable agenda for the next 45 minutes?"

Getting up front agreement opens up doors for you and keeps your calls and meetings on target.

### Tip # 6: Leave Room to Negotiate

This may go without saying, but it's surprising how many people make this mistake. Once you know the most you can pay for a property, don't make an offer at that number, make it 5-10% below to leave some room to negotiate.

### Tip # 7: Use The "Range" Technique

If the seller says, "I'm looking for $1.3M," then affirm that with, "OK, so what I hear you saying is that you're looking for somewhere between $1.2M and $1.4M, gotcha." Most times he'll say, "That's right", and you just knocked $100K off his price. Sometimes, he'll catch your shenanigans and emphasize that the number is $1.3M - oh well, at least you tried.

### Tip # 8: Use Negative Phrasing

Imagine you're buying car, and it's a few years old and showing some wear and tear. You meet the seller and say, "Boy, this car's looking a little rough, no?". The seller is likely to defend his car and point out all of the good things about it and why his asking price is fair.

Now imagine you approach the same seller and say "This is a fabulous car, it looks brand new!" To this the seller might say, "Well, it's not really that new. I mean, the seats are a bit cracked and the AC doesn't work, but it's a good little car."

In this scenario, the seller is actually criticizing his own car!

Do the same thing when talking about the building you just toured today and make the listing broker tell you what the issues are!

### Tip # 9: Affirm What the Other Person is Saying

After the person says whatever he says, repeat back what he said to show that you're actively listening. Even though you're not necessarily agreeing with what the other person said, you are building rapport by paraphrasing what he just said.

### Tip # 10: "No" is better than "Maybe"

It is better to get the person to say "no" instead of "maybe" or even "yes" when they really mean "no". Many times, people are uncomfortable in telling you "no"; make it easy for a person to say what they really feel.

You can say something like "I don't want you to do anything you don't feel 100% comfortable with. My sense is that holding a note like we've been talking about really won't work for you, fair?"

This will often get the other person to admit that yes, this or that won't work for them. This is good because now you're not chasing something that probably won't happen, and it opens up the dialog.

## Putting It all Together

Let's assume you're meeting with the Steve, who is selling his 22-unit apartment building and is asking $2.1M. You got his financials, did your analysis, and know that you shouldn't pay more than $1.8M for this building. You just finished touring the building with him and now you're at Starbucks to talk turkey. Applying all of our negotiation skills we learned so far, this is how this conversation might go:

**You**: "Hi Steve. Thanks for the tour - you really have a lovely building, it's in such great shape!" (Negative Phrasing)

**Steve**: "Well, thanks ... It's a nice little building but it's got its issues."

**You**: "It looked great to me!"

**Steve**: "Well, I'm having trouble with three of the tenants, they're chronically behind in their rent. There are a few units that need some attention, and several of the furnaces need to be replaced. But we'll get to all that later. Anyway, I'm looking for $2.1M for the building."

**You**: "So you're looking for somewhere between $2M and $2.1M?" (Range Technique)

**Steve**: "Yeah ... More like $2.1M" (at least you tried!).

**You**: "Well, I tried to estimate the net operating income from the financials you gave me. You had a few expenses missing I think. For example, I didn't see any expenses for legal fees, or pest control, but more importantly, you manage the building and I will be using a management company, so the expenses are likely higher than in the financials.

Buildings similar to yours in this area have been selling for an average cap rate of 8%. Based on my calculations, the actual net operating income with a property manager would be $144,000, and at an 8 cap, that would put the value of the building at no more than $1.8M, quite a bit lower than what you're asking. And that's assuming your vacancy rate is 10% as reported, you're actually collecting the rent, and there's no deferred maintenance. How are you justifying the $2.1M asking price?"

**Steve**: "This is just the price I need".

**You**: "I can certainly understand that. (Affirming) But at that asking price, the cap rate would be under 7%, and no building like this is selling for that! I know you're set on this price, but do you agree that using an 8 cap on the net operating income as we talked about is a reasonable way to come up with a fair market price, and you want a fair price, don't you?

**Steve**: "Of course, I want a fair price."

**You**: "But $2.1M doesn't appear to be a fair price. Should we stop talking?" (Negative phrasing)

**Steve**: "Well, I would consider something under $2.1M, but not much."

**You**: "Hypothetically, let's say we agree on something lower like $1.9M, which is still above what we would need to pay. And I don't think that would work for me and my partner, but let's assume we could do that (Reluctant Buyer). Would you consider holding back a note with a reasonable interest rate and repayment period? (What if).

**Steve**: "I'm not sure, I haven't thought about it. What did you have in mind?"

**You**: "Well I'm not sure either, we're just brainstorming here (What if). But if you were to hold a note for say like $300,000 with a balloon after 5 years, that would reduce the amount of money I would need from my partners which is expensive capital. If we could do that, I might be able to pay a little bit more than fair market value. Is that something you would consider, or probably not?" (Negative phrasing).

**Steve**: "I might, if the price is right."

**You**: "I think we're still quite a way apart Steve, but there's a chance we can still work something out. How about I give you a couple of proposals, one without a note, and one with - what do you think?"

**Steve**: "Sounds good, I look forward to hearing from you."

## Effectively Negotiating via a Broker

It is ideal to negotiate directly with the seller in-person. You should always work to try to arrange that whenever possible. This allows you to establish rapport and more quickly talk through different scenarios to try to reach an agreement.

Most often, however, the broker will make sure you don't get the chance to do that. This means you need to negotiate through the broker, and this is most often done in writing, with the broker relaying documents and emails between you and the seller.

Aggravating, but a reality of life.

Even if you negotiate with the seller in person, like in our skit earlier, there comes a point where the negotiation will be in writing.

This is why your ability to effectively negotiate in writing is critical if you want to get deals done.

The stages of making an offer in writing are typically:

- Informal emails and/or phone calls;
- A Letter of Intent; and
- A formal Purchase Contract.

Some sellers and their brokers are very formal, other sellers are more casual. Adapt your approach accordingly.

For example, one seller of a 20 unit building told me he wanted me to give him a 1-page summary of my offer in plain readable English - he didn't want to see anything longer. My

"standard" Letter of Intent is more like three pages long, so I had to simplify it down to one page.

## Testing the Waters with Informal Offers

Long before the purchase contract is ever submitted, there's lots of negotiation going on. If you just throw over a contract for consideration (which is perfectly acceptable for single family houses), you're just wasting everybody's time.

As we now know, negotiating apartment building deals is all about the numbers. But one common challenge is that you rarely get the chance to negotiate with a seller face-to-face because it's normally done through a broker. Therefore, you have to get good at communicating your rationale (i.e. how you "underwrote" the deal to arrive at your offer price) to both the broker and the seller. If they can follow your underwriting, then you have a better chance at getting agreement on your offer price.

Let's talk about two ways to test the waters with informal offers:

1. **Write a letter or email**: One thing I've done for a long time is to put my offer underwriting in a long letter to explain how I arrived at the offer price. This is a perfectly acceptable way to accomplish the same goal, but it's very time consuming.
2. **Submit a video analysis**: Another way to achieve the same goal is to email the broker and/or seller a video recording of your analysis and assumptions.

Let's develop both of these tips a bit further.

### Tip # 1: Write an Informal Email or Letter

Below is an example of a negotiation letter that I emailed to the listing broker to be presented to the seller. I was supposed to have met the seller at a walk-through, but he couldn't make it. The asking price was $1.32M. I used the Syndicated Deal Analyzer to present the seller with three different scenarios to try to get close to his asking price.

*Dear Mr. Seller :*

*Sorry for missing you this week, but Caleb did a nice job showing the property. I am pleased to present this Letter of Intent to purchase the Harbor Terrace apartments. This is non binding on either party but represents a good faith effort to begin discussions which are to be concluded with a contract of sale once we get agreement on terms. I'd like to propose to you two scenarios for your consideration: Option 1 is that we base the purchase price on current rent roll (which is 4 vacant units), and Option 2 is that we base the price on a fully leased building and make the contract contingent on that.*

*In addition, I identified several improvements I would want to make to the property, which I need to factor into my overall purchase price and financial model.*

| Estimated Repairs | | |
|---|---|---|
| # Units | | 22 |
| Repair allowance per Unit | | $2,000 |
| **Total repair allowance** | | **$44,000** |
| # of Windows | | 44 |
| Cost per window | | $450 |
| **Total Windows** | | **$19,800** |
| # Sliding doors | | 22 |
| Cost per door | $ | 600 |
| **Total Doors** | $ | **13,200** |
| **2 Security Gates to entrance of each building** | $ | **5,000** |
| **2 awnings** | $ | **2,000** |
| **Secure front gate with key lock** | $ | **2,000** |
| **Landscaping** | $ | **2,000** |
| **Fence blinds** | $ | **2,000** |
| **TOTAL** | | **$90,000** |

*These are just rough numbers, I will have to firm this up during due diligence, but I think they are close.*

***Option # 1: Price with current rent roll***

*My offer price for taking the building as-is is $1,010,000, please see my assumptions below.*

| PURCHASE | | | |
|---|---|---|---|
| # Units | 22 | | |
| Asking Price | $1,010,000 | | |
| Purchase Price | $1,010,000 | | |
| Price Per Unit | $45,909 | | |
| Down Payment | $303,000 | 30% | |
| Loan Amount | $707,000 | | |
| Interest Rate | 6.00% | | |
| Amortization | 25 | | |
| Term | 25 | | |
| Closing Costs | $47,835 | 4.7% | |
| Acquisition Fee | $10,100 | 1.0% | |
| Repairs | $90,000 | | |
| Total Initial Investment | $450,935 | | |
| **P&L** | | | |
| Gross Scheduled Income | $290,100 | | |
| - Vacancy | -$52,745 | 18% | 4 of 22 units vacant |
| = Effective Rental Income | $237,355 | | |
| + Other Income | $0 | | |
| Gross Operating Income | $237,355 | | |
| Expenses | $106,312 | 45% | |
| Net Operating Income | $131,043 | | |
| Debt Service | $54,663 | | |
| Cash Flow After Debt Service | $76,380 | | |

***Option # 2: Higher price contingent on lease-up***

*If you are able to turn the building over completely leased up I can pay up to $1,270,000, please see below.*

| **PURCHASE** | | | |
|---|---|---|---|
| # Units | 22 | | |
| Asking Price | $1,270,000 | | |
| Purchase Price | $1,270,000 | | |
| Price Per Unit | $57,727 | | |
| Down Payment | $381,000 | 30% | |
| Loan Amount | $889,000 | | |
| Interest Rate | 6.00% | | |
| Amortization | 25 | | |
| Term | 25 | | |
| Closing Costs | $54,915 | 4.3% | |
| Acquisition Fee | $12,700 | 1.0% | |
| Repairs | $90,000 | | |
| Total Initial Investment | $538,615 | | |
| **P&L** | | | |
| Gross Scheduled Income | $290,100 | | |
| - Vacancy | -$14,505 | 5% | Fully leased and |
| = Effective Rental Income | $275,595 | | 5% vacancy factor |
| + Other Income | $0 | | |
| Gross Operating Income | $275,595 | | |
| Expenses | $106,312 | 39% | |
| Net Operating Income | $169,283 | | |
| Debt Service | $68,734 | | |
| Cash Flow After Debt Service | $100,549 | | |

*This price might appear to be far below the asking price, but if you sold this on the open market via a commercial broker, your 6% commissions would cost you $84,000, so the offer price is equivalent to a contract price of $1,354,000 from a broker, just over the asking price. I hope we can make this work.*

*For this option, we would make the contract contingent on your ability to completely lease up the building. I would prefer this option because it reduces the risk of the operation, and I suspect you might prefer this option also because of the higher price. My requirement is, however, that I get to veto any new tenant you put in; in other words, I have a chance to review the tenant before a lease is signed. That way we can be sure we have a quality tenant in there.*

***Option # 3: Higher Price with some Seller Financing***

*My understanding is that you are looking for a min. price of $60,000 per unit, which is equivalent to a $1,320,000 sales price. The only way to achieve that is if you agree to hold a note. In order to achieve the same returns as Option # 2 (but with a higher price), you would agree to hold a $100,000 for a term of 10 years at a competitive interest rate like 5.25% (which is what I got for my last building). This would have to be a second mortgage subordinate to the bank's mortgage.*

*That's it for the price, here are some of the other proposed terms of the purchase:*

- *Purchase Price: See above*

- *Cash Down Payment: 30% of purchase price.*
- *Deposit: $5,000*
- *Balance: commercial loan plus possibly some seller financing.*
- *Name of Buyer: I will create a new entity for the purchase of this building. I will sign the purchase contract as Picket Fences Properties LLC and then we will assign it to the new entity when it is created.*
- *Study Period: 14 days from the time I receive all of the information I have requested*
- *Closing: 90 days from completion of study period (we will tell the bank 60 days but they get stressed with only 60 days to close). Or we can do 60 days with a 30 day extension.*
- *Closing to be held with Michael Gross Esq (I have used him before).*
- *Closing costs: We will equally share the closing costs except that each party will pay for its own legal representation fees*
- *"Normal" prorates to occur on the day of the close (taxes, utilities, rents, insurance).*
- *Other: I will not sell the property to a third party or assign this agreement without your permission.*

*Thanks very much for your consideration. I look forward to hearing from you.*

If this doesn't get the negotiation going, nothing will! If you don't hear back, you probably missed the mark and the seller is not motivated enough to respond.

But if you're in the ball park, you'll get a response. Either the seller with question your assumptions or counter your offer price. They might even agree to meet with you to try to iron out a deal.

Keep it informal at first to get the conversation going. Once you have a general agreement on price and terms it's time to take it to the next step, the Letter of Intent.

**TIP:** This letter is also in Document Library > Making Offers > Informal Negotiation Letter to Seller.doc.

**Tip # 2: Submit Your Analysis and Offer with Video**

Another good way to test the waters with an informal offer is to email the broker and/or seller a video recording of your analysis and assumptions.

I use a free program from Techsmith called "Jing" which lets me do a video capture of all or part of my screen. The free product is limited to a 5-minute recording, but you shouldn't need more than that to articulate yourself.

Here's an example of a video I submitted to a broker for a deal that I was negotiating.

http://youtu.be/pA4HgpawBgw

I then emailed the video to the broker along with my offer price. Here's how he responded:

"*Brilliant! It reminds me of the Kahn Academy videos I often watch. I will have to use this going forward. I am going to forward this to my clients and we will jump on a call together to discuss and I should have some feedback for you by tomorrow hopefully.* "

Perfect, that's exactly what I wanted. I wanted the seller to understand my rationale, and the video makes sure that nothing is lost in translation.

He also added: "*We have other offers coming in on this property, but my clients were pleased with your presentation and the details in your LOI. We anticipate a level of savviness engaging you as the buyer as opposed to the others whom we are in the process of vetting.*" So the video analysis also adds a certain level of professionalism which will set you apart from other buyers.

**Conclusion**

It's critical that you can effectively communicate to the seller how you are underwriting the deal and how you are arriving at your offer price. And since you're normally negotiating through a broker, a video is an excellent tool to help get your next project under contract!

## The Letter of Intent

Once you have agreement on the general terms, then the next step in making written offers is the **Letter of Intent (LOI)**. The LOI is a short document that outlines the major terms of a deal. It is not legally binding, but used as a tool to get agreement in preparation of a formal purchase contract.

Take a look at the complete Letter of Intent in the Document Library > Making Offers > Letter of Intent.doc. Here are the highlights with some commentary.

***Purchase Price***: *The Purchase Price shall be $1,900,000 payable as follows:*

- *$15,000 Earnest Money Deposit.*

  The EMD is typically around 1%. The less is better in terms of tying up cash, but more is better in terms of getting the seller's attention. The key is to balance those two competing factors. My opinion is that 1% of the purchase price is a good number, and you can slide up or down from there depending on which objective is more important to you. Another consideration is a stepped EMD. For example, $17,500 at contract execution and another $17,500 when you waive the due diligence contingency.
- *$555,000 to be paid at closing in cash or certified funds.*
- *$1,330,000 from conventional bank of other institutional mortgage loan.*

***Proposed Time Frame***: *Seller will submit a Purchase and Sale Agreement (the "Agreement") to Buyer with respect to the purchase and sale of the Property within ten*

*(10) business days from the date this letter of intent is fully executed and accepted by both parties. Once Seller delivers to Buyer due diligence documents, Buyer will have 21 days after receipt of requested due diligence documents to complete his due diligence ("Inspection Period"), and 60 days after that to close.*

The seller wants to know when you're going to close. Spelling it out in a clear, logical progression gives the seller confidence in your process. Note that the Inspection Period starts only **after** the seller has given you all the documents you requested. That way, if the seller drags his feet or gives you incomplete information, you can rightly argue that you weren't able to start your Inspection Period.

Most lenders will require 45-60 days to close from the time you order the appraisal (which is the green light for the lender to begin the loan process). This time frame interestingly enough is about the same for small as well as larger properties.

The next three sections are pretty self-explanatory.

***Deposit****: Within 48 hours of the Effective Date of this Agreement, Buyer will deposit EMD with ______________ (the "Title Company"). After the Inspection Period, if Buyer wishes to move forward, Buyer will waive physical contingencies and Deposit will be applied as credit to purchase at closing.*

***Closing****: The Closing of the purchase and sale contemplated herein shall occur at the office of the Title Company or as otherwise mutually agreed by Buyer and Seller. Closing shall take place 60 days after the expiration of the Inspection period.*

***Access****: Seller agrees to provide Buyer and any third party contractor engaged by Buyer (i.e. roofing contractor, etc.) reasonable access to the Property during the time*

This one requires some commentary:

***Assignment****: This letter of intent may be assigned upon written consent of the seller and shall be binding upon and inure to the benefit of the parties hereto, and their successors and assigns.*

Most likely, you will put your LLC as the buyer in whatever contract you end up drafting up. You may not have the LLC created yet, which is OK. You can use as the buyer name "New Entity to be Created" or you can use an LLC you already have. Regardless, by the time you close, you should use a new LLC you create just for this building. For this purpose, you will change the name of the buyer later on, in other words, you will want to "assign" the contract to another entity. This clause gives the seller a head's up that this may be a possibility.

**TIP**: The Document Library also contains a simpler version of the Letter of Intent which is only a page long. I developed this for a seller who said they wanted a simple one pager -;) See Document Library > Making Offers > Letter of Intent (Informal One Pager).

## Purchase Contracts that Keep You in Control

Once you have the Letter of Intent signed by both parties, you can send it to your attorney to draft the purchase contract.

It will cost you about the same amount of money to have your attorney review someone else's contract or modify one of their own. Therefore, it's always best to get the seller to agree that your attorney will draft the purchase contract.

There are two forms of purchase contracts that are used:

1. A custom agreement drafted by an attorney is the most common used purchase contract because with commercial real estate deals, **everything** is negotiable.
2. The standard state commercial sales agreement used by licensed agents and brokers are used sometimes, especially for smaller deals.

Let's discuss each in turn.

### Using a Standard Commercial Sales Agreement

An example Realtor Multi-Unit Sales Agreement (used in the Washington, D.C. area) is in the Document Library > Making Offers > MLS Multi-Unit Sales Contract.pdf.

Another example is a purchase and sales contract used by Marcus & Millichap. See Document Library > Making Offers > Marcus & Millichap Commercial Real Estate Purchase and Sale Agreement.pdf.

These "standard" contracts are usually very long and tedious because they try to cover all possible scenarios. Because they're written to be as neutral as possible between the buyer and seller, there are several important clauses that will likely be missing from the standard agreement that you should add using a short addendum.

The complete Addendum is in the Document Library > Making Offers > Addendum to Standard Realtor Contract.doc.

**Here are the highlights:**

*Buyer has final approval of any new or changes to rental agreements, service contracts, or leases between Ratification Date until closing.*

You want to prevent any major changes to the tenants and service providers after you've done your due diligence. Otherwise you'll find that the seller signed a bunch of leases with poorly qualified tenants and now you have to go evict them. You want to be able to review and possibly veto any new leases or changes to service contracts while you have the property under contract.

*The Due Diligence Period referenced in the Purchase Agreement shall begin once Buyer receives all of the requested information.*

In standard agreements, the due diligence clock just starts ticking from the date of ratification. On several occasions, the seller took their sweet time to give me documents,

and when they did, half of them were missing or incomplete. In this way, the seller ate up most of my allotted due diligence time and I didn't have enough time to inspect everything. I solved this problem by having the seller sign an addendum to extend the inspection period. But this clause solves this problem entirely and starts the inspection period only when you've received all of the documents you have requested. Very useful.

*Buyer's rights hereunder may be assigned to a partnership, corporation, or other party, and any such entity shall have all the benefits and rights that the Buyer has under this agreement. If this agreement is assigned, Buyer shall be released from any further liability hereunder and the Assignee(s) will accept all responsibilities, privileges, covenants, conditions and obligations as set forth in this entire Agreement.*

Many standard contracts are not assignable. This clause makes sure you can assign the contract later.

*To the best of Seller's knowledge, no part of the property is in violation of any existing code, health or safety regulations, and is not involved in any governmental or judicial proceedings. Seller is not aware of any structural defects or adverse geological or environmental conditions affecting the property and its value.*

This gives you an out if you discover later, even after your inspection period, that the building is in some kind of violation that is material enough to change the deal for you negatively. You can then either terminate the contract or re-negotiate the terms.

This clause saved me with my 12-unit building because we discovered later that the building was not compliant with local rent control requirements. The title company discovered this after the due diligence period had expired, and technically I was on the hook to close regardless. This clause helped justify the addition of a specific contingency to address this non-compliance.

*Buyer has the right to extend the date for closing / of escrow by releasing to the Seller until closing / through escrow an amount equal to one-quarter of one percent of the purchase price for each 30 day extension requested, to be applicable to the purchase price, with Buyer to maintain at all times the current deposit, as set out in the Purchase Agreement, with Closing Agent / in escrow.*

This clause is a way of allowing you to extend the closing date by 30 days by paying 0.25% of the purchase price into escrow as an additional earnest money deposit.

This clause again came in handy with the same apartment deal because my initial lender decided not to move forward with the loan at the last minute. Without losing the deal, I was able to exercise this option to extend the contract another 30 days in return for some additional earnest deposit money. Also very useful!

### Using a Custom Purchase Contract

The contract I use is in the Document Library > Making Offers > Sales Agreement-Template.doc.

**Note that while I have used this contract, you MUST have your attorney review it for you and your specific situation.**

Study my contract carefully so that you are familiar with the most important clauses. That way, when you do get the contract from your attorney and you don't see some of these clauses, you can instruct the attorney to add them.

We've already discussed most of the important clauses previously, and so I'm going to highlight only those clauses we haven't already discussed.

*MORTGAGE CONTINGENCY. Within 7 days after the expiration of the Inspection Period, Buyer shall submit a complete mortgage loan application to apply for mortgage loan of $_____________ at prevailing rates terms and conditions. If despite the Buyer's diligent efforts a commitment for such a loan cannot be obtained on or before 30 days after the expiration of the Inspection Period, the Buyer may terminate this agreement by written notice to the Seller and/or the Broker(s), as agent(s) for the Seller, prior to the expiration of such time, whereupon any payments made under this agreement shall be promptly refunded and all other obligation of the parties shall cease and this agreement shall be void without recourse to the parties.*

This introduces a financing contingency to the contract. It says that despite your best efforts, you can't get a competitive loan for the property, you can void the contract. This is really handy because normally, once your inspection period expires, you're on the hook to close. And if you don't close, you lose your earnest money deposit. Not so good. Just be aware that the seller may try to negotiate this clause away.

*CLOSING & POSSESSION DATES: Time is of the essence. The sale shall be closed and the deed delivered on or before 30 days after the removal of all contingencies.*

This defines the closing date in terms of removal of all contingencies. The last contingency to be removed is the financing contingency. Most banks will tell you they need 60 days to close from the time you pay to order the appraisal. I use the first 30 days as part of the financing contingency, and the other 30 days to close.

After 30 days, you should know whether you're going to get the loan or not. If not, you can always try to extend the contingency until you get a firm commitment from the lender.

In any event, once you know you're going to get the loan (expiration of the financing contingency), most banks will be able to close within 30 days.

Stay away from fixed dates in your contracts. Closings rarely go as planned. Making milestones depend on certain conditions being met gives you flexibility without being in default of the contract.

## How to Amend a Contract with Addenda

Use the template below to amend any of your Contracts. The example below extends the Due Diligence Period by 30 days. My comments are in italic (remove them from your final version!)

**ADDENDUM TO CONTRACT**

THIS ADDENDUM of _______________ *[Insert the date]* hereby amends and modifies the Purchase Agreement dated ______________ *[Insert the date]* (the "Agreement"), by and between ______________ ("Seller") and ____________ ("Buyer").

The parties hereby amend the Purchase Agreement in accordance with the following. In the event of any conflict or ambiguity between the terms of this Addendum and the Agreement, the terms of this Addendum shall control.

WHEREAS the parties wish to extend the Feasibility Study by 30 days. *[State in plain English language what you intend to do with this addendum]*

The parties, then, agree to the following:

1. Section 10 of the Purchase Contract shall be restated as follows: "This Contract is contingent until 9pm ______________, for the Buyer, at Buyer's expense, to determine the feasibility of the Property for Buyer's purposes". The rest of Section 10 shall remain the same.

IN WITNESS WHEREOF, the parties hereto have executed this Addendum as of the date first written above.

| ________________________ | _____________________ | _______________ |
|---|---|---|
| Seller – Print Name | Seller Signature | Date |
| ________________________ | _____________________ | _______________ |
| Buyer – Print Name | Buyer Signature | Date |

## Chapter Summary

In this section we reviewed:

- 10 Negotiation tips to get your offers accepted
- Effectively negotiating in writing via a broker
- Testing the Waters with Informal Offers
- Submitting a short but to-the-point Letter of Intent
- Purchase contracts that keep you in control.
- How to amend purchase contracts with addenda.

Hopefully you now have all the tools to confidently negotiate your deals and make offers that get accepted.

# Chapter 7: Perform Due Diligence To Avoid Mistakes

You have a deal under contract - congratulations! Now the real works begins.

The goal of due diligence is to

- Validate information you received from the broker or seller (such as financial information, property condition, etc);
- Uncover any new information that could materially alter the deal negatively;
- Update the Syndicated Deal Analyzer as you get new information to see if the deal still works or if you need to re-negotiate or possibly get out of it.

## Delay Spending Money As Much As Possible

Be smart about spending money during due diligence. Do as much as possible upfront and delay spending any money as long as possible.

For example, if you hired a property inspector to inspect the property (which costs money) BEFORE reviewing the financials (which is free) and you decide not to pursue the deal then you've spent money you won't be able to recover at closing.

So do everything that costs no or little money first, and then, and only then, move on to things that will cost money. That way you minimize your risk and increase the chances of closing.

Don't be misled by other gurus who tout "no money down" techniques: you will need cash to get through to closing. If it's not your own cash (that you get back at closing), then it could be cash from one of your investors. In return for the extra risk, you could offer them extra equity in the deal.

I will outline roughly what things will cost leading up to closing. Make sure you have the cash to go the distance, otherwise you will be wasting everybody's time and get a reputation for not getting the deal done.

## Due Diligence Checklist

An acceptable time for you to reasonably complete your due diligence is 14 to 30 days **after** you've received all documents from the seller. The smaller the property, the less time it takes.

Request 14 days for 25 units or less, 21 days for 26 to 100 units and 30 days for larger buildings.

> **TIP:** The entire check list for weeks one to three are in the Document Library > Due Diligence > Due Diligence Checklist.doc.

Let's get started.

Here's a step by step checklist of what to do in the three weeks after you ratified your contract.

## Week 1

**Send a Letter to the Seller Requesting Due Diligence Documents**

One of the first things you should do is send a letter to the seller requesting all of your due diligence documents. The seller often will take their time producing this information, and it may be woefully incomplete. The sooner you start this process the better.

Here is the letter to send:

*Hi Bill,*

*In order to complete my due diligence on the property located at ______________ ________, I will need the information below. I understand that some of the requested information may not exist or it may not be applicable, but please do your best to supply as much as you can. Please fax everything to 555-555-5555, mail it to ____________ _______________ or email it to me (best!) at your earliest convenience.*

- *Rent roll: setting forth the rates, security deposit, lease terms, concessions, unit type, beginning date, expiration date. Include payment history for each tenant for the last 6 months, including any late payments collected and how much the tenant owes. Identify any existing evictions in progress.*
- *Copies of all leases and rental applications.*
- *Copies of all utility statements from the past year.*
- *Copies of service contracts showing term of contract, monthly cost for services, work performed, and termination penalty for: Pest Control, Trash Removal, Landscaping, Janitorial Service, Parking Lot Sweeping, Snow Removal, Security.*
- *Copies of the last two years' profit and loss statements, or summary of expenses.*
- *Operating bank statements from last two years.*
- *Copy of Schedule E from last two years*
- *List of all improvements made in the last 5 years*
- *Copy of current management agreement*
- *Copies of all insurance policies and insurance company contact info.*
- *Copies of last two years' property tax bills*
- *As-built surveys showing any improvements to the property*
- *Owner's Title insurance binder*

**TIP:** This Letter is in the Document Library > Due Diligence > Letter to Seller to Request Due Diligence Documents.doc.

- *All notes trust deeds, and other documents relating to title to, and liens or debts against, the subject property, and title insurance commitment.*
- *Mortgage document or letter from current lender(s) showing the current balances and terms of the mortgages.*
- *A written inventory of all furnishings and other personal property in, on, or commonly in use for the normal operation and maintenance of the subject property. Identify personal property that will not convey.*
- *Copies of all warranties for appliances, equipment, utilities, roof, paving, pool, etc.*

**Tour the Property and Inspect the Units**

In this visit, you should have your contractor with you and look at the inside of as many units as possible. The goal of this visit is to make a list of all of the repairs and improvements you would want to make to the property after you close.

It's possible that you will discover things you didn't catch during your first property visit. If these findings are significant enough, you will either terminate the contract or negotiate different terms. For example, you might negotiate a repair credit at closing to pay for things that either weren't disclosed to you upfront or you discovered on your site visit.

Make a list of all repair items and have your contractor give you an estimate for all items. We'll use this information later to make sure the deal still works.

The walk-through of the 12-unit building revealed some items I wasn't aware of before. For example, the contractor found a smell coming from the gas meters outside; the gutters needed some work; some exterior lights were not working. My contractor estimated it would cost $2,350 to address these items, so why not request this as a repair credit at closing?

Because the units in this building needed a lot of work, I wanted a detailed list of items that needed to be renovated in each unit. I took careful notes and a video of each unit as we walked through it. After a few units, I couldn't remember which one was which, so the videos and notes were priceless. I then turned the notes and videos into a Property Inspection report (see the Document Library > Due Diligence > Property Inspection Report - 12 Unit.doc) that I gave to the contractors for bids.

If you're uncomfortable doing the inspection yourself, you can hire a professional apartment inspector. It'll cost you about $250 per unit, so it adds up, but it may be the price worth paying for piece of mind. The inspector will give you a detailed report of all of the issues that need attention. Be sure to accompany the inspector.

Once I get the bids back (hopefully next week or the week after), I will run them through the Syndicated Deal Analyzer to make sure the deal still works or if I need to re-negotiate it.

**Perform a rent survey**

Getting a handle on the prevailing market rents is critical for your business plan for the building. Your building's rents may be under market, but how do you know for sure? What rents should you use for your financial projections?

A rent survey answers these questions.

For type of unit in your building, note what kind of unit it is (1, 2, or 3-bedroom), how many square feet the unit is, whether or not utilities are included, and what amenities the building has.

Create a spreadsheet to compile rents from the different sources below:

**Tip # 1: Use Rentometer.com to do an arm chair rent analysis.** Just type in an address and type of unit you're looking for, and the web site tells you what the median rent is and also shows you a map of the units.

rentometer

Register or Sign In Marketplace

Address: 1600 Pennsylvania Avenue Northwest, W | $ 0 | bedrooms | Analyze My Rental →

**Rental comparison results for: 1600 Pennsylvania Avenue Northwest, Washington, DC, States**

**Please provide the price you pay in monthly rent for analysis.**

Rent 1990

**Your results are based on:**

- **50** any size rentals
- ...in a **0.20** mile radius.
- Median rent: **$1650**
- Average rent: **$1990**
- 20th / 80th percentile: $1088 / $3130
- 10th / 90th percentile: $895 / $3500

**Tip # 2: Visit other sites like Apartments.com and Craigslist.com** and search for similar units in the area. Note the size and price of these units in your spreadsheet.

**Tip # 3: Ask a real estate friend to get you access to the local Multiple Listing Service (MLS).** There, you can search for rented apartments, and it'll give you the rented price, how long it took to rent, and usually at least a photo.

**Tip # 4: Visit listed apartments**. You can do a lot of work online, but you're missing one piece of important information: the condition of the area, the building, and the unit itself

- these all affect the rent of an apartment. The only way to get this information is by visiting some of the apartments you found online.

Make a list of some of the apartments in the immediate area of your building and make an appointment to see them. After seeing them yourself, you can more readily compare them to your building.

You might also learn things from visiting these other buildings. For example, maybe the competition has some advantages, like access to washer/dryer or an awning. Or maybe they're offering a free month of rent free as an incentive.

Information like this gives you ideas of how you can be the most competitive you can be. First-hand knowledge also makes your financial projections more reliable and also more believable to the investors.

**Tip # 5: Get a rental survey from your property manager**. The better property managers ALWAYS have current rent surveys on hand. They know the condition, size and price of competing units and know about any type of specials or concessions. These surveys are GREAT because they're normally very comprehensive and up to date.

**Tip # 6: Get rental comps from your broker**. If the building you're looking at is listed by a larger, reputable broker, then chances are good that the broker has access to rental comps in that market.

If you put several of these tips to work for you, you will get a more accurate picture of not only the rental comps but the local market itself.

### Validate the actual rents by sending a letter to the tenants

Sometimes your seller "exaggerates" the rents he's getting in his financials and/or the security deposit he's actually holding for each tenant. You can validate this information once you get the leases, but you can also verify them by sending a letter to some or all of the tenants. Here's a sample letter you could use:

*Dear Mr. Johnson,*

*My name is Michael Blank and I work for Better Homes LLC, a small, family-owned business that invests and manages in real estate in the Washington DC area* [Don't make it sound like you're the owner, you're just an employee trying to do your job]*. Better Homes LLC has the building you're living in under contract for purchase. I wanted to confirm some of the information provided to us by the current owner to make sure we got everything right and we don't accidentally charge you the wrong rent. Here is what was reported to me:*

TIP: This Letter is in the Document Library > Due Diligence > Letter to Tenant to Verify Lease Information.

*You live in Unit # 104. Your monthly rent amount is $750. Your security deposit was $500. You are currently on a month-to-month lease. You are currently paying your own electric, gas, and cable bills.*

___ *Yes, this is correct.*

*___ No, this is not quite right, here's what I think it is: __________________________*

*What is the best number to reach you (in case we have a question): ________________*

*PLEASE use the enclosed self-addressed stamped envelope to return this letter back to us today if you can. Thanks so much for your help in this matter.*

*I'm thrilled to be able to write you today and I hope to meet you in person soon.*

*Sincerely,*

What I like to do is not have all my facts straight. For example, if the seller reports $725 for this unit, I put $750 in the letter. This increases the likelihood that the tenant will indeed mail back the letter to assert that she's actually paying $725.

You have to use your best judgment before mailing this letter. For example, the current owner may not want the tenants to know the building is being sold. While you can send anyone you want a letter via U.S. mail, you may consider communicating with the seller before doing so.

### Create the Deal Package

I discuss in detail how to create your Deal Package in "Chapter 1: How to Raise Money from Private Individuals to Fund your Deals" - now is the time to create your **real** Deal Package to send to your investors and lenders.

### Request Term Sheets From Lenders

We'll talk in detail about dealing with banks and loan officers in "Chapter 8: Financing the Deal". This is the time to initiate the process with your lenders.

### Send the Deal Package to your Investors

Send the Deal Package to your investors and ask them what level of financial investment they are interested in. If you don't hear back in a 2-3 days, call each investor and try to get a "yes" or "not at this time" out of them.

By this point, the investor should already be comfortable with you and be familiar with your sample Deal Package. You may have to answer some questions or concerns about this particular deal and maybe even meet face-to-face, but you shouldn't need more than several days to get an answer one way or another. If an investor isn't entirely comfortable in moving forward, that's OK - keep working on her but move on for this deal.

### Get Insurance Quotes

Contact your insurance agents to request a quote. The cost of insurance sometimes varies widely, so make sure you get two or three quotes. Send them your Deal Package and the tax record of the building. They might ask you a few more questions, but the application process is fairly painless.

## Week 2: Review the Seller's Documents and Re-Evaluate the Deal

Hopefully this week you'll get most or all of the documents from the seller. Remember, you should have 14-30 days from receipt of all documents to complete your due diligence. You'll want to review most of the documents from the seller before spending any money (such as ordering the appraisal or paying an attorney to begin drafting documents).

Our primary goal is to validate (or invalidate) the actual and projected income and expenses with the documentation we receive from the seller. Based on what we find, we either move ahead with the deal as it is, re-negotiate new terms, or get out of the contract.

Here's the process we're going to use in this step:

1. **Step # 1: Update Our Version of the Actual Income and Expenses**
2. **Step # 2: Update the Projected Income and Expenses**
3. **Step # 3: Incorporate the Repair Estimate**
4. **Step # 4: Re-Evaluate the Deal**

Let's get started.

### Step # 1: Update Your Version of the Actual Income and Expenses

In this step, your goal is to revise the actual financials by researching what the actual income and expenses really are. When you get the financials from the broker or the seller, you have to treat them with a healthy dose of suspicion. That's because the seller and/or his broker will try to make the property seem as attractive as possible!

As we discussed in Chapter 5 "Sharpening Your Pencil: When (and How) to Overpay", we learned that the Scenarios tab allows you to put multiple financial scenarios side by side. We use it to compare what the seller reported, what our version of the truth is, and what we think the situation would be like after the first year.

We're going to re-visit the Scenarios tab and update it with information we uncover during due diligence. Here's what we had in Column # 1 from the end of Chapter 5, which documents the income and expenses reported by the seller:

| INCOME | Reported | |
|---|---|---|
| Gross Potential Income | $85,740 | |
| - Vacancy | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% |
| Effective Gross Income | $77,166 | |
| Other Income | $0 | |
| **Total Gross Income** | **$77,166** | |

| EXPENSES | Reported | |
|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% |
| Insurance | $5,100 | 6.61% |
| Water and Sewer | $7,200 | 9.33% |
| Electric | $1,200 | 1.56% |
| Gas | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% |
| Management Fees | $0 | 0.00% |
| Legal Fees | $0 | 0.00% |
| Contract Services | $600 | 0.78% |
| Repairs and Maintenance | $10,900 | 14.13% |
| General/Admin | $0 | 0.00% |
| Payroll | $0 | 0.00% |
| Other | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | $0 |
| **Total Expenses (Added)** | **$33,928** | **43.97%** |
| **Total Expenses (Manual Override)** | $33,928 | 43.97% |
| **Total Expenses** | **$33,928** | |

As we already noticed earlier, the seller is not reporting any property management expenses - and you will likely have some. Her repair and maintenance number is a bit vague because it seems to be a combination of repairs and legal fees. The real estate taxes look suspiciously low, too.

What we want to do here is to revise Column # 2 "My Version" with information that we get from the seller, that we research ourselves, or that we assume based on rules of thumb. Then we plug those numbers into the Syndicated Deal Analyzer to see how it affects the deal. Let's examine the income first, then the expenses.

***Examine the Income***

To re-examine the income, your sources at this point are the supplied rent roll, the leases that tell us what the rent is per unit and what units are currently empty, bank statements, and possibly a tax return. You can check those numbers with an income and expense statement if the seller provided one.

Back to our case study. If you add up all the rents as provided, the Gross Scheduled Rents are $7,145 per month. It says that the occupancy rate is 10%, but **two** units are currently empty. You don't have a ledger or rent roll for the last 12 months, and the broker assures you that the two empty units are a temporary anomaly. In addition, your property manager confirms that a 10% vacancy rate for this area is conservative

because it's such a desirable area. For this reason, you'll continue to use the 10% vacancy in the Income section of the "My Version" column.

Now, check out the leases (if you have them) and compare the rents in the leases with the rents in the rent roll. Are there any differences? If so, ask the seller why there are differences. At this point, you may consider sending some of the tenants a letter (like we discussed in Week 1) to confirm the actual rents.

The next question you should answer is, **"what has been each tenant's payment history? Are the tenants actually paying their rent?"**

This question would be adequately answered with a ledger (or accounting) of income received for each unit **plus** either a bank statement or tax return that documents the income. In many cases, however, the seller does not keep books in this way and either can't or won't give you that information. So it's sometimes difficult to tell what a tenant's payment history really is, but getting to the bottom of this mystery is important.

Otherwise you get into the deal thinking you have a 10% vacancy rate but half the tenants aren't paying their rent!

What to do?

The first thing to do is to ask the seller for this information. "Please give me an accounting of all rents and late fees collected, and the current balance for each unit." If the seller doesn't have this information readily available, insist that she create it for you, at least for the last 12 months. And also insist on at least bank statements or a tax return for the building.

**Whatever you do, you need something to verify actual rents being collected**.

In the case of our 12-unit building, the seller did or could not provide an accounting of income of each unit, but she did provide bank statements. Unfortunately, she deposited her rents into her personal account, and it was impossible to tell what were rents and deposits from other sources.

You ask her to highlight which of those deposits were rent deposits. It takes her a few days to get back to you. She was supposed to collect about $6000 in rents each month (assuming the two vacant units), but she was only depositing about $3,000 each month.

**What ?!?** Either only half the tenants are paying their rent, or she was depositing them into another account. You write her broker a letter, asking for clarification, and the response was that the tenants have been having a tough time because of the economy.

Really? Well, then you offer just went from $485,000 to half that.

Needless to say, this information is a showstopper for you. You wouldn't have discovered this unless you had spent the time reviewing the seller's documents and asking the right questions.

Establishing an exact picture of the income side is critical. The expense side of things are (1) easier to establish from service statements etc and (2) can be more easily estimated if no information is readily available. However, if you can't reliably verify what rents are

being collected, I strongly advise that you move on to another deal, otherwise you are taking unnecessary risk.

In fact, there is a line item in both the Summary and P&L tab to accommodate something called "**Bad Debt**". Bad Debt is rent that is not collected because of delinquency.

**Moving On ...**

For the purposes of this exercise, we'll assume that you verified the leases and actual rents collected, and they match what was initially reported. So we'll keep the numbers we have in the Syndicated Deal Analyzer. Otherwise, if you're underwriting a building with bad debt, then add that to the Syndicated Deal Analyzer.

OK, let's take a closer look at the expenses.

### *Examine the Expenses*

Hopefully by now you received records from the seller that will help you validate (or invalidate) what she's actually spending. You might have utility bills, trash collection invoices, and tax records. If not, you might have to call the vendors directly (with an authorization from the seller) and find out what the expenses were. And if all of that fails, you might have to use rules of thumb.

Let's go back to the Scenarios tab and look at each of the expenses in Column # 2 "My Version".

**Introducing Rules of Thumb**

In this section you'll examine the documentation you received from the seller. But if they're missing, you may have to rely on rules of thumbs. To help you with this, the Syndicated Deal Analyzer has a rule of thumb for each of the expenses.

To expose the rules of thumb in the Scenarios tab of the Syndicated Deal Analyzer, click the button that says "Show Rules of Thumb" (see screen shot below).

**Side-by-Side Scenarios**

| Acquisition Cost | Seller Disclosed | My Version | Projected | Offer |
|---|---|---|---|---|
| Price | $515,000 | $430,000 | $540,000 | $460,000 |
| # Units | 12 | 12 | 12 | 12 |
| Price Per Unit | $42,917 | $35,833 | $45,000 | $38,333 |
| Downpayment % | 30% | 30% | 30% | 30% |
| Downpayment $ | $154,500 | $129,000 | $162,000 | $138,000 |
| Loan Balance | $360,500 | $301,000 | $378,000 | $322,000 |
| Estimated repairs | $0 | $0 | $0 | $0 |
| Estimated closing costs 2.5% | $12,875 | $10,750 | $10,750 | $10,750 |
| Total Member Capital Needed to Close | $167,375 | $139,750 | $172,750 | $148,750 |
| **Total Acquisition Cost** | **$527,875** | **$440,750** | **$550,750** | **$470,750** |

| INCOME | Reported | | My Version | | Projected | | Offer | |
|---|---|---|---|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $85,740 | | $108,000 | | $85,740 | |
| - Vacancy | ($8,574) | 10.00% | ($8,574) | 10.00% | ($10,800) | 10.00% | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $77,166 | | $97,200 | | $77,166 | |
| Other Income | $0 | | $0 | | $0 | | $0 | |
| **Total Gross Income** | **$77,166** | | **$77,166** | | **$97,200** | | **$77,166** | |

| EXPENSES | Reported | | My Version | | Projected | | Offer | |
|---|---|---|---|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Insurance | $5,100 | 6.61% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Water and Sewer | $7,200 | 9.33% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Electric | $1,200 | 1.56% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Gas | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Management Fees | $0 | 0.00% | $0 | 7.00% | $0 | 7.00% | $0 | 7.00% |
| Legal Fees | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |

Show Rules of Thumb

To show the Rules of Thumb

This exposes some cells to the right (see below) which contain the rules of thumb to use to estimate expenses when we don't have any other information.

| Projected | | Offer | |
|---|---|---|---|
| $108,000 | | $85,740 | |
| ($10,800) | 10.00% | ($8,574) | 10.00% |
| $0 | 0.00% | $0 | 0.00% |
| $97,200 | | $77,166 | |
| $0 | | $0 | |
| **$97,200** | | **$77,166** | |

| Projected | | Offer | |
|---|---|---|---|
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 7.00% | $0 | 7.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 10.00% | $0 | 10.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | 0.00% | $0 | 0.00% |
| $0 | $0 | $0 | $0 |

Hide Rules of Thumb

To show the Rules of Thumb for each of the Expenses, click the button above.

| | |
|---|---|
| **Sales Price** | $515,000 |
| **# Units** | 12 |
| **Effective Gross Income** | $77,166 |

| | General Rule of Thumb | |
|---|---|---|
| | | Per |
| **EXPENSES** | **Comment** | **Total** |
| Real Estate Taxes | .01 of Sales Price | $ 5,150 |
| Insurance | 0.007 of sales price | $ 3,605 |
| Water and Sewer | $400/unit | $ 4,800 |
| Electric | $100/unit for common areas. If owner pays, use $100/unit/month. | $ 1,200 |
| Gas | If owner pays, $100/unit/mnth | |
| Trash Removal | $200 per unit | $ 2,400 |
| Management Fees | 5-10% of Gross Income | |
| Legal Fees | 1% of Gross Income | $ 772 |
| Contract Services | $200 per unit per year | $ 2,400 |
| Repairs and Maintenance | 10% of Gross Income | $ 7,717 |
| General/Admin | Varies | |
| Payroll | | |
| Other | | |
| Replacement Reserves | $150 per unit | |

I'll reference these rules of thumb in the discussion that follows.

**Line-by-Line Review of the Expenses**

Let's look at each of the expense line items and update the "My Version" column with our findings.

**Real Estate Taxes**: Most of the time you can access a property's tax record for free online. Among other things, the tax record contains the annual real estate taxes to be paid for the property. If the tax record is not readily available, you can call the local tax assessor's office and ask for the published tax rate and the assessed value of the property and calculate the tax yourself.

As a rule of thumb, use 0.01 of the sales price.

In our case, the seller reported the taxes as $3,300 but the actual tax in the public tax records was **$5,336**. So much for credibility!

But, the assessed tax value of the property is $670,000 and the contemplated purchase price is $485,000, so this might present us with the opportunity to challenge the assessed value once we close and reduce the annual taxes to about $4,400.

**Insurance**. The seller reports **$5,100** for her annual insurance premium. The rule of thumb to use is 0.007 of the sales price, which would put the insurance at around $3,395. Since you don't have an insurance quote for this building yet, you will keep the higher number that was reported by the seller.

**Water / Sewer**: The seller reports $7,200 for this expense. The rule of thumb is $400/unit/per year, which would be $4,800. After adding up her water bills from the last 12 months, her total expenses were $5,901, which is lower than she reported initially but more accurate. You'll use **$5,901** here.

**Electric**: If the units are separately metered (as is the case with this building), the rule of thumb is $100/unit/year for common areas. If the owner pays electric, use $100/unit/month. The seller reports **$1,200** per year, which is consistent with the rule of thumb, so you'll keep it.

**Gas**: If the owner pays gas, the rule of thumb is $100/unit/month. In this case, the tenants pay for their own gas, and there is no gas used to heat the common areas. So this expense is **$0**.

**Trash Removal**. The seller initially reported $5,638 per year for trash removal, but her actual invoices for the last 12 months was **$5,448**. The rule of thumb is $200 per unit per year, so $2,400 per year. Her number seems high (an opportunity), but for now, you'll use her higher number.

**Management Fees**. The seller has not been using a property manager, so her expense is $0. You already know that your property manager will charge you 7% of collected rents, so you'll use that number in you version of the expenses (**$5,402**). The rule of thumb is 5-10% of income - the smaller the building, the higher the percentage.

**Legal Fees**. The default rule of thumb is $150 per unit for legal fees. In this case that would be **$1,800**, which is the number you'll use. Note that the projected legal fees will vary depending on the kind of asset you're considering, i.e. is it a high-maintenance building with a high expected delinquency or a Class A building in the best part of town?

**Contract Services**. This includes janitorial services, pest control, landscaping, snow removal. The seller initially reported $600 per year but you didn't get any receipts from her for actual expenses. The rule of thumb is $200 per unit per year, or **$2,400**. You'll use the higher number.

**Repairs and Maintenance**: The rule of thumb is 10% of income, or **$7,717**. The seller reported that she spent $5,000 last year and $10,983 the year before. It looks like she included legal fees in this number (odd). It's clear that you won't get an exact number

from her, so we'll stick with our rule of thumb number. Note that this number is above and beyond the $25,000 in improvements and repairs you already budgeting into the deal.

**Admin**. This includes tax preparation fees and bookkeeping. I don't have a rule of thumb for this because it depends on whether you will do your own books and how much your CPA charges you for tax prep. You assume that the seller (and you) does her own "Admin" and keep this expense at $0.

**Replacement Reserves**

Replacement Reserves is for you to "save" money each month to pay for capital improvements down the road. For example, maybe the roof needs to be replaced in 5 years, or the boiler, hot water heaters, etc. Unless you want to take care of these as soon as you buy the building and you have that in your repair budget that you allocated for this purpose, then you should escrow money each month and put it into a separate bank account for these kinds of capital expenses.

The Rule of Thumb for Replacement Reserves is $250 per unit per year. For this 12-unit, that would be $3,000 per year that you would be paying into the Replacement Reserves bank account.

This would be an expense on the P&L but the cash would transfer to the balance sheet until it's used. Assuming that you do use it during the life of the investment, then the money ultimately would be spent and would therefore reduce the overall returns.

Adding Replacement Reserves into the P&L is rarely done by either brokers or owners. Doing so is conservative but advisable, and you want to underwrite this deal conservatively, so let's add $250 per door (**$3,000**) to the Scenarios tab.

Now that you completed each of the expense line items, you should have the following in Column # 2 "My Version":

| INCOME | Reported | | My Version | |
|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $85,740 | |
| - Vacancy | ($8,574) | 10.00% | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $77,166 | |
| Other Income | $0 | | $0 | |
| **Total Gross Income** | **$77,166** | | **$77,166** | |

| EXPENSES | Reported | | My Version | |
|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $5,336 | 6.91% |
| Insurance | $5,100 | 6.61% | $5,100 | 6.61% |
| Water and Sewer | $7,200 | 9.33% | $5,901 | 7.65% |
| Electric | $1,200 | 1.56% | $1,200 | 1.56% |
| Gas | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $5,448 | 7.06% |
| Management Fees | $0 | 0.00% | $5,402 | 7.00% |
| Legal Fees | $0 | 0.00% | $1,800 | 2.33% |
| Contract Services | $600 | 0.78% | $2,400 | 3.11% |
| Repairs and Maintenance | $10,900 | 14.13% | $7,717 | 10.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | $0 | $3,000 | $0 |
| **Total Expenses (Added)** | **$33,928** | **43.97%** | **$43,303** | **56.12%** |
| **Total Expenses (Manual Override)** | $33,928 | 43.97% | $43,303 | **56.12%** |
| **Total Expenses** | **$33,928** | | **$43,303** | |
| | | | | |
| **Net Operating Income (NOI)** | **$43,238** | | **$33,863** | |

As you can see, your version of the truth produces higher expenses (**56% of income!**) and therefore a much lower Net Operating Income.

According to this analysis, the building is worth less than we thought. But how much less?

***Re-Evaluating the Purchase Price***

Based on our due diligence so far, you can make the valid argument that the real estate taxes were under-reported by $2,000 as well as the legal fees and contract services. Here are these three expenses side by side:

| EXPENSES | Reported | | My Version | |
|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $5,336 | 6.91% |
| Insurance | $5,100 | 6.61% | $5,100 | 6.61% |
| Water and Sewer | $7,200 | 9.33% | $5,901 | 7.65% |
| Electric | $1,200 | 1.56% | $1,200 | 1.56% |
| Gas | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $5,448 | 7.06% |
| Management Fees | $0 | 0.00% | $5,402 | 7.00% |
| Legal Fees | $0 | 0.00% | $1,800 | 2.33% |
| Contract Services | $600 | 0.78% | $2,400 | 3.11% |
| Repairs and Maintenance | $10,900 | 14.13% | $7,717 | 10.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | 0.00% | $3,000 | 3.89% |
| **Total Expenses (Added)** | **$33,928** | **43.97%** | **$43,303** | **56.12%** |

You initially underwrote the deal with expenses at 50% to accommodate some of the (expected) under-reporting. You then added $3,000 of replacement reserves, but you can't fault the seller for your conservative underwriting, so it's difficult to use that as an argument that expenses were actually higher than reported.

But, you **can** use the under-reported taxes, legal fees and contract services to your advantage. These three together push your total expenses from 50% to 52%. This 2% increase in expenses is equivalent to a difference of $1,543 per year. At a cap rate of 8%, that is equivalent to a $20,000 decrease in value ($1,543 / 8%).

The broker would theoretically agree with this logic. Whether you can actually negotiate a price drop remains to be seen. But for now, update the Summary tab with Expenses of 56% and the Purchase Price to $465,000 to get the following:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $465,000 | |
| Price Per Unit | $38,750 | |
| Earnest Money Depost (EMD) | $4,650 | 1% |
| Down Payment | $139,500 | 30% |
| 1st Mortgage | $325,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,520 | 8.3% |
| Acquisition Fee | $13,950 | 3.0% |
| Repairs | $25,000 | |
| Total Member Capital Needed to Close | $216,970 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $43,213 | 56% |
| Net Operating Income | $33,953 | |
| Debt Service | $25,166 | |
| Cash Flow After Debt Service | $8,787 | |
| **KEY INDICATORS** | | |
| Cap Rate | 7.30% | |
| Cash on Cash Return | 4.05% | |
| Debt Coverage Ratio | 1.35 | |
| Gross Rent Multiplier | 5.42 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 50% | |
| Manager Equity | 50% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $8,787 | |
| Member Cash on Cash Return (Year 1) | 4.05% | |
| Average Annual Return ...................... | 12.52% | |
| IRR | 11.15% | |

This now drops your return for the investors to 12.5%, which is below your target of 15%. Before you consider adjusting the terms for your investors or how you pay yourself (the two other options besides price you have to adjust the returns), let's re-visit our projected financials with the information you've been able to uncover so far. There's a chance that this will affect the deal one way or another. You'll then decide what to do about the price or investor terms you have right now.

### Step # 2: Update the Projected Income and Expenses

The seller initially reported expenses of 44%, you underwrote the deal with 50% and discovered that the **actual** expenses were in fact 52%. Then you added another 4% for replacement reserves and now your expenses are at 56%. You updated the Summary tab with expenses of 56%. This in turn makes the Year 1 expenses in the P&L tab also 56%. Since the expenses go up by 3% each year, Year 2 and beyond will continue to increase by 3%. This, of course, affects the entire model in a material way.

We found that some of the actual expenses are higher than our rules of thumb, so there may be an opportunity to lower some of the expenses as soon as you own the building. If that's the case, then there's a possibility you might be able to decrease your expenses over the next 3 years in addition to increasing the rents. If that's true, then that would impact the financial model and returns positively.

Let's make another pass through all of the projected expenses.

Let's review each of the projected expenses in Column # 3 ("Projected") and update them with what we've learned.

- **Real Estate Taxes**: In your version, the actual real estate taxes on this property were $5,336 on a tax assessment of $670,000. Tax assessments are typically based on purchase price and most jurisdictions have a process for appealing those assessments. After closing, you could appeal the assessment based on a lower sales price. There's no guarantee, but if approved, the annual tax would be **$4,250**. Let's add that number to the "Projected" column for this expense.

- **Insurance**. The seller is reporting an annual insurance cost of $5,100. You asked for quotes from your insurance brokers last week and you already got one quote back for **$3,200**. Awesome!

- **Water / Sewer**: You confirmed that actual expense for water and sewer was $5,901. The rule of thumb is $400/unit/per year, which would be $4,800. You speak with your property managers and ask them what consumption is like in their buildings. They confirm the rule of thumb, so you stick with the **$4,800** for your first year projection.

  You know that the seller has not been managing the property efficiently, and so it's likely that everything is leaking and dripping, which explains the high water bill. With your planned renovations and better management (including regular unit inspections to check for leaks and drips), you should be able to achieve a lower water consumption.

- **Electric**: The seller reports **$1,200** per year, which is consistent with our rule of thumb, and also with the electric bills she provided. So you'll keep that number.

- **Trash Removal**. The actual expenses are $5,448 per year for trash removal. The rule of thumb is $200 per unit per year, so $2,400 per year, so her number seems high. You call two other trash services and get quotes for around $200 per month for smaller trash cans that should be sufficient for 12 units. It turns out the seller is using larger trash containers than she needs. Your revised number is now **$2,400** per year.

- **Management Fees**. You'll continue to use 7% of income for this figure.

- **Legal Fees**. You don't have any other information to the contrary, so you'll stick to the rule of thumb of $150, per unit, which is $1,800 per year.

  If you wanted to be more diligent in this step, you could speak with one of your potential eviction attorneys, and ask him how much the process costs, and what he estimates the cost will be for this area. But he would probably also speculate.

  For now, you stick with your rule of thumb.

- **Contract Services**. This includes janitorial services, pest control, landscaping, snow removal. The seller provided no service contracts for this, so it looks like you're on our own. The broker did mention that one of the tenants provides these services, and that he was being paid about $175 per month. Pest Control will cost about $25 per unit per year, so $200 all in (which is our rule of thumb), or **$2,400** per year.

- **Repairs and Maintenance**: As soon as you purchase the building, you will address all of the repairs uncovered during the walk through. You're going to renovate the two vacant units. Once you do all that work, the repairs should be "normal", and so you'll stick to the rule of thumb of 10% of income, or **$7,717**.

- **Admin**. You'll get the P&Ls and balance sheet from your property manager, which you can then give to your CPA. Your CPA will charge you **$700** for tax prep, which is a bit high but you also have a handful of investors who will need to get K-1's, which costs more.

- **Replacement Reserves**: You stick with $250 per unit or **$3,000** per year.

Updating our third column "Projected" in our "Scenarios" tab gives us the following:

| INCOME | Reported | | My Version | | Projected | |
|---|---|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $85,740 | | $85,740 | |
| - Vacancy | ($8,574) | 10.00% | ($8,574) | 10.00% | ($8,574) | 10.00% |
| - Concessions, Loss to Lease, Bad De | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $77,166 | | $77,166 | |
| Other Income | $0 | | $0 | | $0 | |
| **Total Gross Income** | **$77,166** | | **$77,166** | | **$77,166** | |

| EXPENSES | Reported | | My Version | | Projected | |
|---|---|---|---|---|---|---|
| Real Estate Taxes | $3,300 | 4.28% | $5,336 | 6.91% | $4,250 | 5.51% |
| Insurance | $5,100 | 6.61% | $5,100 | 6.61% | $3,200 | 4.15% |
| Water and Sewer | $7,200 | 9.33% | $5,901 | 7.65% | $4,800 | 6.22% |
| Electric | $1,200 | 1.56% | $1,200 | 1.56% | $1,200 | 1.56% |
| Gas | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $5,628 | 7.29% | $5,448 | 7.06% | $2,400 | 3.11% |
| Management Fees | $0 | 0.00% | $5,402 | 7.00% | $5,402 | 7.00% |
| Legal Fees | $0 | 0.00% | $1,800 | 2.33% | $1,800 | 2.33% |
| Contract Services | $600 | 0.78% | $2,400 | 3.11% | $2,400 | 3.11% |
| Repairs and Maintenance | $10,900 | 14.13% | $7,717 | 10.00% | $7,717 | 10.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% | $700 | 0.91% |
| Payroll | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Replacement Reserves ($250) | $0 | 0.00% | $3,000 | 3.89% | $3,000 | 3.89% |
| **Total Expenses (Added)** | **$33,928** | **43.97%** | **$43,303** | **56.12%** | **$36,868** | **47.78%** |

Note that the expenses are just under 50% **including** capital reserves that make up 4% of income. While you can't be guaranteed that you can achieve lower expenses after the first year, the probability is high that you can do better than the 56% of current expenses.

You feel confident that you can decrease expenses from 56% to 50% in three years.

Remember, you are projecting that your rents will increase from $595 to $750. Increasing the rents will not normally increase your expenses significantly. Therefore, if you project that your expenses will drop from 56% to 50% in three years, then you have to calculate that based on the current income.

| INCOME | My Version | |
|---|---|---|
| **Total Gross Income** | **$77,166** | |
| **Total Expenses at 56%** | **$43,213** | **56.00%** |
| **Total Expenses at 50%** | **$38,583** | **50.00%** |

Therefore, 56% of current income of $77,166 is $43,213. If you were able to reduce those expenses to 50%, then that would be $38,583 per year. Now, let's apply those numbers to your projected Gross Income of $108,000 in Year 3:

| INCOME | Projected | |
|---|---|---|
| **Total Gross Income** | **$108,000** | |
| **Total Expenses** | **$38,583** | **35.73%** |

That means that if you could get the expenses down to $38,583 and increase rents to $108,000, then your expenses would be 36% of income. This would be outstanding!

However, this doesn't take into account the annual increase of expenses of 3% per year. And you want to conservative in your underwriting. So you decide that instead of projecting expenses of 36% in 3 years, you feel more comfortable in using 45% in your underwriting.

To update your model with this information, head over to the P&L tab and override the Total Expenses with 45% in Year 3 and 50% in Year 2, as follows:

| INCOME | 1 | | 2 | | 3 | |
|---|---|---|---|---|---|---|
| Gross Potential Income | $85,740 | | $95,000 | | $108,000 | |
| - Vacancy | ($8,574) | 10.00% | ($9,500) | 10.00% | ($10,800) | 10.00% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Effective Gross Income | $77,166 | | $85,500 | | $97,200 | |
| Other Income | $0 | | $0 | | $0 | |
| **Total Net Income** | **$77,166** | | **$85,500** | | **$97,200** | |
| | | | | | | |
| **EXPENSES** | | | | | | |
| Real Estate Taxes | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Insurance | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Contract Services | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Trash Removal | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Electric | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Gas | $0 | | | | | |
| Water and Sewer | $0 | | | | | |
| Legal | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Management Fee | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Repairs and Maintenance | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| General/Admin | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Payroll | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Other | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| Deposit to Replacement Reserve | $0 | 0.00% | $0 | 0.00% | $0 | 0.00% |
| **Total Expenses** | **$43,213** | **56.00%** | **$42,750** | **50.00%** | **$43,740** | **45.00%** |
| | | | | | | |
| **Net Operating Income (NOI)** | **$33,953** | | **$42,750** | | **$53,460** | |

You'll notice that with this underwriting, your expenses actually stays about the same but your percentage of income is going down. That's because you're increasing the rents. This is a fairly conservative projection because if you recall, there is lots of opportunity to decrease expenses over this time frame. So chances are, you can do even better than projected, but you want to under-promise and over-deliver, right?

Before we re-evaluate the deal, let's make sure we take into account the actual repair estimates we got from our contractors.

### Step # 3: Incorporate the Contractor's Repair Estimate

You submitted your property inspection report to at least three contractors in Week 1, so hopefully by now you will have received bids from all three. You want to plug in your

preferred contractor's repair estimate into the Syndicated Deal Analyzer to see what happens to your numbers.

If the repair estimate is about what you thought it would be (or less), everything's cool. If it's substantially over your initial estimate, you'll have to see what the increased repairs will do to the deal's underwriting.

In the case of your 12-unit building, we initially estimated repairs of $25,000, but your favorite contractor's quote came in at $32,000. This wasn't the low bid, but you know it'll get done right by this contractor.

OK, now it's time to see where you are with this revised underwriting and re-evaluate the deal.

### Step # 4: Re-Evaluate the Deal

Go back to the Summary tab of the Syndicated Deal Analyzer and see what all of your revisions did to your investors' returns.

- In Step 1 you increased the actual expenses and adjusted the purchase price by $20,000 (to accommodate the additional expenses you discovered) and decreased it from $485,000 to $465,000.
- In Step 2, you optimized your expenses slightly and updated the P&L tab.
- In Step 3, you updated the repair estimate from $25,000 to $32,000.

Here's what the Summary tab in the Syndicated Deal Analyzer should look like:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $465,000 | |
| Price Per Unit | $38,750 | |
| Earnest Money Depost (EMD) | $4,650 | 1% |
| Down Payment | $139,500 | 30% |
| 1st Mortgage | $325,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,520 | 8.3% |
| Acquisition Fee | $13,950 | 3.0% |
| Repairs | $32,000 | |
| Total Member Capital Needed to Close | $223,970 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $43,213 | 56% |
| Net Operating Income | $33,953 | |
| Debt Service | $25,166 | |
| Cash Flow After Debt Service | $8,787 | |
| **KEY INDICATORS** | | |
| Cap Rate | 7.30% | |
| Cash on Cash Return | 3.92% | |
| Debt Coverage Ratio | 1.35 | |
| Gross Rent Multiplier | 5.42 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 50% | |
| Manager Equity | 50% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 1% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $8,787 | |
| Member Cash on Cash Return (Year 1) | 3.92% | |
| Average Annual Return ........................ | 13.39% | |
| IRR | 11.79% | |

As you can see, the investors' average annual return is now just over 13%. And that's assuming you can negotiate $20,000 off the current contract price.

There is no question that you should ask for a $20,000 price reduction based on the increased expenses you discovered during due diligence. Let's assume that after your best efforts, you and the seller decide to split the difference, and the seller agrees to drop the price by $10,000 to get the deal done. Now the purchase price is $475,000.

Update the Summary tab with the new price to see if you should go ahead with the deal or get out of the contract.

If you update the purchase price to $475,000, the average annual return for the investors drops to just under 13%. This is below your 15% target you were aiming for. What to do?

You can do what you always do when the returns aren't quite what you want. You can:

1. Lower the purchase price. But we already our best and $475,000 is the best we can do, so this option is out.
2. Give the investors a higher return;
3. Pay yourself less; or
4. Get out of the deal.

You decide that you will:

- Not pay yourself the 1% asset management fee; and
- Increase the investors' equity from 50% to 60%.

If you do that, then your average annual return is back up to just under 15%. Perfect.

Now you're Summary tab looks like this:

| INVESTOR RETURNS | |
|---|---|
| Member Equity | 60% |
| Manager Equity | 40% |
| Preferred Return to Members | 5.0% |
| Asset Mgt Fee to Manager | 0% |
| Capital Transaction Fee to Mgr | 1% |
| Cash Flow to Members (Year 1) | $8,245 |
| Member Cash on Cash Return (Year 1) | 3.62% |
| Average Annual Return ........................ | 14.68% |
| IRR | 12.75% |

**Summary of Week 2**

Here's what you did in Week 2:

- **Step 1**: You reviewed the seller's actual income and expenses in great detail, captured the information in the Scenarios tab, and then updated the Summary tab to see what effect the new information has on the projections. You discovered expenses that were about 2% of income higher than what you used to underwrite the deal to come up with your offer price. You decided that in order to accommodate these additional expenses, a $20,000 price reduction is justified.
- **Step 2**: You then examined the expenses to see what opportunity you have to reduce them over the course of the next one to three years. You decided that as

you increased rents you could conservatively achieve expenses that are 45% of income. You updated the P&L tab with your updated business plan.

- **Step 3**: You got our contractor's estimate back, but it was a bit higher than you estimated at first. You updated the Summary tab with the higher repair estimate.
- **Step 4**: You then requested a $20,000 price reduction based on the increased expenses. You and the seller agreed to split the difference, and you adjust the Purchase Price in the Summary tab to $475,000. This still leaves the investor returns slightly low, and you decide to not pay yourself an asset management fee and increase the investors' equity to 60%. You now are back to your target of 15% annual average return for your investors.

## Week 3

You've had a busy Week 2!

Assuming you're happy with the contract price you negotiated, it's time to move on to Week 3 of your Due Diligence.

### Order Initial Title Report

Ask your closing attorney to do a quick online title search for the property. This shouldn't take more than a few days. Only a full title report will tell all (and you won't order that until Week 4), but by the end of next week, you should know of any glaring title-related issues that the seller needs to address.

### Research the Tenants

Another thing you should do (which I didn't but I should have) if you have questions about the quality of the tenants is to research their litigation history at the local court house. Some jurisdictions have this information readily online, others you have to appear in person. Either way, it's public information.

You want to be concerned with any tenant that was evicted previously or is currently involved with a legal matter with the seller. If someone has experience with an eviction, you know that tenant will be a pain to get out if you need to evict him or her. The more legal activity you find with your prospective tenants, the more of a red flag it throws up.

> *In the case of my 12-unit, I did this research **after** I closed because they were giving me so much trouble. When I did do the research (more so to satisfy my curiosity) I discovered that the two tenants that were causing problems were the two tenants who were constantly in and out of court. Ugh. Had I not skipped this step ahead of time, I might not have proceeded with the deal.*

### Hire the Property Manager

You've been building your team for a while, and now it's time to pick your favorite property management company. Go ahead and sign a property management agreement that is contingent on you actually closing on the property.

### Finalize Commitments from Your Investors

You've been interacting with your potential investors about this specific deal for at least a week. Now it's time to confirm that commitment from your investors verbally or via email. Ideally, you want to get commitments for at least 1.5 times the capital you need to close on the deal. Inevitably, there are some investors who get cold feet, and being over-committed protects you from this.

One way to do this is to go back to your investors and ask if they might be able to invest a little more if needed. Many say "yes" and then you don't need to go out and find new investors.

If you are over-subscribed, establish a system for picking one investor over another. You can tell people that you will honor their commitments in the order you receive them. That creates something like a waiting list, which is not a bad thing!

### Order Lead Paint Certification

Lead paint laws are still evolving in the United States and are being enforced to varying degrees. In many parts of the country, lead paint laws are taken very seriously. Becoming compliant can be expensive, and so can violations (up to $25,000 per day!). You should research your local laws and ask around how serious they are. In any event, lead paint laws will continue to become stricter as time passes.

> *This is a step I skipped with my 12-unit building because, well, I was ignorant about lead paint laws. I ended up ordering the lead inspection after I closed, so I didn't save any money by skipping the step and it cost me a bunch of money to address the issues. I should have asked the seller to address these items or either reduce the purchase price further or get a repair credit.*

#### *A Quick Crash Course on Lead Paint Laws*

I'll give you a quick crash course on lead paint laws as I understand them for Washington, D.C. and Maryland. Again, they may be different in your area, but at least it will make you sensitive to them.

You can be either **lead-safe** or **lead-free**.

**Lead-safe** means that there is lead-paint in the building, but it's not flaking or chipping.

**Lead-free** means that there is either no lead-paint at all, or it has been covered in some way as to never be exposed.

Becoming lead-free is obviously ideal, but depending on the scope of the lead paint, it may be cost prohibitive.

Therefore, being lead-safe is the only other option. In order to stay lead-safe, you have to make sure you don't have any flaking or chipping paint anywhere. You may have to disclose to your tenants that the building contains lead paint but is lead-safe. You may have to pass a dust swipe test before an "at-risk" tenants moves in. An "at-risk" tenant is a young child or pregnant woman. But since you can't ask a woman if she's pregnant,

and you may not know if the woman has her granddaughter visiting 5 days a week, it's safer to do the dust-swipe test before any new tenant moves in.

Often, any contractor that works in a building with lead paint has to be lead-paint certified.

All I'm saying is: spend some time researching the local lead paint laws to make sure they don't bite you later on!

> *My building thankfully didn't contain any lead paint in any of the units. But the staircase railing did. It's very expensive to "get rid of lead paint" and it's not necessary to be lead free. You just need to make sure lead paint isn't exposed in any way. I ended up going with the "lead-free" option, which involved wrapping the stair case railing in dry wall. We also had to wrap the exterior window framing in aluminum.*

## Time to Decide

Before the expiration of your due diligence period, you should have finalized your financial due diligence and property inspections (repairs, renovations,  lead paint). You should have a good feeling regarding the commitments from your investors.

In other words, you should have a fairly high degree of confidence that the deal works and that you want to move forward with closing. If you don't feel good about it, exercise your due diligence contingency and terminate the contract or re-negotiate the terms so that the deal works again

## Chapter Summary

Here are the key points to remember in this chapter:

- **Delay spending money as much as possible**. Do as much as you can that doesn't cost money and only proceed with spending money if you're still happy with the deal.
- **Follow your due diligence checklist**. I know it's a lot of work, but don't cut corners!
- **Revise your Syndicated Deal Analyzer as you find new information**. Constantly re-evaluate the deal and make adjustments if necessary.
- **Decide!** Do you want to stay in the deal, do you need to exercise your due diligence contingency and terminate the contract, or do you need to re-negotiate a lower price or repair credit?

# Chapter 8: Financing the Deal

One of the nice things about commercial real estate is that banks are very willing to finance them because of the low perceived risk. This means that a vast majority of your deals will be financed by a bank.

In this chapter, we explore creative ways to finance your deal, and you should always be on the look-out for these opportunities. But in most cases, traditional financing is the norm. This is why we spend most of the time talking about how to get the best conventional financing. We'll talk about building relationships with multiple lenders, the loan process, timing and terms, how to create a loan package that lenders will say "Yes" to, and how to pick the best lender for your deal.

## Creative Financing Techniques

Before we talk about the more traditional bank financing, let's look at these, more creative ways to finance builds:

1. Seller Financing;
2. Assume the Existing Financing;
3. Purchase the Property Subject to the Existing Mortgage; and
4. Purchase the Building with a Master Lease.

### Option # 1: Seller Financing

You should always ask for seller financing. You can offer a slightly higher purchase price for seller financing because it reduces your cost of capital and the amount of money you need to raise from investors (it may eliminate need for investors entirely!).

Oftentimes you can get seller financing for a short period of time, like three to five years. This gives you time to stabilize the property, build some cash flow and value, and then re-finance.

When you ask for seller financing, shoot for a realistic interest rate, get at least a three year term, and make sure the seller will “subordinate” his loan. That means the seller agrees to be in the "second position" after the bank loan. Banks will insist to be in first position on the loan - always.

In this scenario, the bank's loan is in first position, then the seller's loan, and then you and the investors.

Did I mention you should always ask for seller financing? Especially if someone is stuck on a higher purchase price, they might agree to that if they're willing to “hold a note”, or if you can assume their existing financing.

***Using the Syndicated Deal Analyzer to Model Seller Financing***

You can use the Syndicated Deal Analyzer to model seller financing (which is the same as a 2nd mortgage):

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $475,000 | |
| Price Per Unit | $39,583 | |
| Earnest Money Depost (EMD) | $4,750 | 1% |
| Down Payment | $142,500 | 30% |
| 1st Mortgage | $332,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $50,000 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,795 | 8.2% |
| Acquisition Fee | $14,250 | 3.0% |
| Repairs | $32,000 | |
| Total Member Capital Needed to Close | $177,545 | |
| Cap Rate at Re-Sale | 8.00% | |

In the Summary tab, add the amount of the 2nd mortgage, the interest rate and term.

As soon as you do this, look at the higher Average Annual Return for the investors (towards the bottom of the page).

Why did it shoot up like that?

While the cash flow went down slightly because of the increased debt service, the amount of money invested was reduced substantially (by the amount of the 2nd mortgage), and that combination increases the returns for the investors.

That's why debt is considered "leverage".

**But be careful**. Make sure that there is enough cash flow to cover the debt service. The indicator that measures that is the "Debt Coverage Ratio" (which we covered in Chapter 5 here).

You can see the Debt Coverage Ratio towards the bottom of the P&L Tab:

| | | | | |
|---|---|---|---|---|
| **Net Operating Income (NOI)** | | **$33,953** | **$42,750** | **$53,460** |
| **Debt Service** | | | | |
| Principal | | $9,824 | $10,399 | $11,008 |
| Interest | | $22,321 | $21,746 | $21,137 |
| Total Debt Service | | $32,145 | $32,145 | $32,145 |
| **Cash Flow available for Distribution** | | **$1,808** | **$10,605** | **$21,315** |
| Distributions from Cash Flow | | | | |
| Asset Mgt Fee to Manager | 0% | $0 | $0 | $0 |
| Members Preferred Return | 5% | $1,808 | $8,877 | $8,877 |
| Excess Cash Flow to Members | 60% | $0 | $1,037 | $7,463 |
| Excess Cash Flow to Mgr | 40% | $0 | $691 | $4,975 |
| **Total Distributions to Members** | | **$1,808** | **$9,914** | **$16,340** |
| **Capital Account Balance (End of Year)** | | **$177,545** | **$177,545** | **$177,545** |
| **Member Cash on Cash Return** | | **1.02%** | **5.58%** | **9.20%** |
| Property Value | 7.0% | $ 485,043 | $ 610,714 | $ 763,714 |
| | 8.0% | $ 424,413 | $ 534,375 | $ 668,250 |
| | 9.0% | $ 377,256 | $ 475,000 | $ 594,000 |
| Debt Coverage Ratio | | 1.1 | 1.3 | 1.7 |

Make sure that the Debt Coverage is at least 1.25, which is the minimum required by most banks and lenders.

If it's not at least 1.25, you need to reduce the amount of the 2nd mortgage.

Therefore, the rule of thumb is:

"Get as much seller-financing as possible, but make sure that the Debt Coverage Ratio is at least 1.25".

**Option # 2: Assume Existing Financing**

Many commercial loans are assumable. It is always an option you should look into. Of course, the terms of the loan will determine whether you should consider it.

Many commercial loans are assumable by paying "points", or a percentage of the loan, ranging from 1% - 2%. This may seem like a lot, but remember, if you get a new loan, you will be paying at least 1% of the loan anyway plus appraisal and a bunch of closing costs. By assuming the loan, you are avoiding most of the bank's qualifying process and closing costs related to getting the new loan.

Obviously, a major considerations for assuming a loan is the interest rate, term, and monthly payment. With historically low interest rates, it often doesn't make sense to

assume an existing loan but to lock in a new one. On the other hand, assuming an existing loan can speed up the closing process if that's what it takes to get the deal done. You can then re-finance later.

### Option # 3: Purchase the Property Subject to the Existing Mortgage

This option involves you keeping the existing loan in place without officially assuming it in your LLC's name. In other words, the previous owner will continue to own the loan. You either have the previous owner continue to make the loan payments and you pay him, or you make the payments to the lender directly (as if they came from the previous owner).

If you do this, the main risk is that the lender gets wind of it and evokes the “due on sales clause” in the loan agreement. This clause gives the lender the right to demand payment of the entire loan balance if the property was sold. They usually give you 30 days to comply, which is a short time for you to refinance.

I realize that some gurus teach this strategy, but I am personally uncomfortable with it. I could justify it if you need to get the deal done in a hurry and you agree to re-finance as quickly as possible, i.e. In 6-12 months.

### Option # 4: Purchase the Building with a Master Lease

This is a cool way to control a property without actually buying it. It involves you signing a lease with the owner that obligates you to pay a minimum amount of rent for the entire building. Typically, the lease payment you're paying leaves room for you to make a profit on the spread between what you're paying to the owner and what rents you can collect.

Let's say the scheduled gross rents for a building are $7,000 per month - assuming all units are rented. Leaving some margin for error, you might negotiate a monthly lease payment of $5,000 per month. You get to keep any income above and beyond your break-even point.

As part of your master lease agreement, you should have an option to purchase the building at some point in the future. Let's say the estimated value of the building is $500,000 based on actual financials. You agree to purchase the building for $525,000 in the next five years. If you don't, the option expires, and the current owner keeps the building. On the other hand, if you can raise rents and increase income, the building might be worth $625,000 in four years. Purchasing the building at that time would be a good deal, right?

The advantage to you with this strategy is that you don't need any cash to gain control of the building; if you do a good job, you will get some monthly cash flow, and you might be able to purchase the building at a lower price down the road, building instant equity.

The reason the owner might consider this is that she doesn't have to worry about the management of the building any more and she gets a guaranteed monthly payment. There is a chance that you will eventually buy the building from her at or above her asking price in a few years.

It might be a win-win situation.

The risk to you is that if you don't do a good job and can't cover the lease payment, you will have a negative cash flow situation, which is not good. You also don't get to benefit from the tax write-offs and loan amortization.

Again, this is a good tool to have in your tool box, but I don't see a lot of deals being done this way.

### Option # 5: Use Crowdfunding for Equity or Debt Financing

"Crowdfunding" is becoming a more popular way to finance commercial real estate.

Crowdfunding is a way for an entity to raise money in small amounts from a lot of people, and this is typically done via Internet portals. This was made possible by the passing of the Jobs Act in 2013.

Most crowdfunding portals have provided **debt** financing. This means they will give you a loan, typically with a 12% interest rate, for 6 to 12 months. This kind of financing is most appropriate for short-term fix and flip projects.

While the majority of deals financed by crowdfunding portals have been for short-term fix and flips, sites like iFunding.co and Fundrise are beginning to fund larger, buy-and-hold commercial deals, and the terms are making it an attractive way to raise equity capital.

Let's take iFunding.co as an example. They will invest alone or alongside your investors. They require payment of 1% of the equity invested payable upfront (before closing unfortunately, and it's non-refundable). They then require a 8% preferred rate of return and some amount of equity (negotiable, between 20% and 50%). If you can get equity with an 8% preferred rate of return and 25% ownership, then this makes crowdfunding a good alternative for raising equity.

Fundrise also provides equity for commercial real estate deals. You pay 2% of the money raised by them and typically a 12% preferred return with 6% paid annually and the rest upon liquidation. They sit in the middle of the "capital stack", i.e. you have up to 65% of cheap conventional financing, they'll provide the capital up to 85%, and you and your investors provide the rest.

Because of the relatively high preferred rates of return that need to be paid out to the crowdfunding investor**, this type of financing is best suited for value-added deals**. This allows you to finance out the crowdfunding investor in 2-3 years and replace them with more conventional financing once stabilized. But it **is** a viable source of funding for modest re-position deals.

This industry is changing so rapidly that by the time you read this, whatever I'm writing will be out of date, and I would need to update it monthly. So Google crowdfunding, research the different sites, and keep up with current trends. I think this is going to be an exciting source of capital for commercial real estate projects.

Now that we've discussed several creative financing techniques, let's turn our attention to the way the majority of commercial projects are financed: by commercial banks and lenders.

## 5 Steps to Get the Best Traditional Commercial Real Estate Financing

Despite very cool creative ways to get deals done, the vast majority of commercial real estate deals are financed by traditional banks and commercial lenders.

Remember that commercial real estate is the one businesses that banks are actually keen to fund. We just have to approach them in a way that makes them want to say "**YES**".

Here's the process for getting lenders to say "Yes" to you and your deals:

1. Determine Loan Terms and Build Relationships with Your Lenders
2. Work with Multiple Lenders
3. Understand the Loan Process and Timing
4. Produce a Loan Package that will get your Lender to say YES!
5. Pick the Best Term Sheet and Lender

### Step # 1: Determine Loan Terms and Build Relationships with Your Lenders

As you reach out to potential lenders and loan officers, your goals are two-fold: (1) identify the lenders you want to work with and build rapport and (2) determine the loan terms so that you know what terms to use for underwriting your deals.

We talked about how to find loan officers in "Chapter 4: How to Build an A-Team", so I assume you already made a list of potential lenders and scheduled meetings with them.

During the meeting, you are selling yourself with the Sample Deal Package and you're qualifying the lender to determine if they provide loans to the type of asset you're looking for (size and geography).

Your third goal is to determine the **loan terms** depending on whether the asset is stabilized or distressed.

- **Stabilized Asset:** These are buildings with at least 90% occupancy. These assets typically qualify for Fannie Mae / Freddie Mac loans that have attractive interest rates and repayment terms.
- **Distressed Asset**: This could be a building that is half or completely empty and may require significant repairs and improvements. Ask your lender what kind of loan products they offer and what the terms are (interest rate, points going in, repayment terms, are monthly payments required or is it a balloon note). Ask them what happens once the asset is stabilized. Does the loan automatically "refinance" (some do) or does it need to be refinanced to a traditional loan.

Ask the lender under what circumstances the loan would be **non-recourse**.

Non-recourse loans are loans that do not require you to personally guarantee the loan (a good thing!). This means that should you ever default on the note the bank can't away

your house and personal assets. So non-recourse loans are great! Typically non-recourse loans are available with a minimum loan of $1M and above - another reason to buy a bigger building!

Ask about the lender's closing fees. This typically consists of a lender origination fee (typically 1%), appraisal fee, document preparation and legal fees. Also ask about the average cost of 3rd party reports that may be required.

Also ask about the lender's **net worth and liquidity requirements**.

Typically the lender requires the sponsors to have a net worth equal to or greater than the loan amount. They may also require that the sponsor has a liquid net worth (i.e. cash and stocks) equal to or greater than 10% of the loan amount.

If you don't have the net worth and liquidity required, don't despair! We'll talk about this more in the section "But Wait! What If My Personal Financials Don't Support the Deal?"

The goal is that you get a really good idea of what the lender's underwriting requirements are for different situations **BEFORE** you put a deal under contract.

Carefully write all of this down somewhere and update the Syndicated Deal Analyzer loan assumptions accordingly.

### Step # 2: Work with Multiple Lenders

You should - no, you **MUST** - work with multiple lenders. Not only will this allow you to pick the best deal but it also gives you a Plan B if one fails to perform.

> *When I was waiting to close on my 12-unit apartment building, my preferred lender's appraisal and their property inspections were fine and we were scheduled to close in 14 days, pending final review by the loan committee. This is normally a formality, but in this case, the bank's loan committee inexplicably decided they didn't want to do the loan. The "explanation" I got was that the loan committee changed their mind about the location and were no longer comfortable with proceeding.*
>
> *Really? 14 days before closing?*
>
> *This is where my previous networking with loan brokers came in handy. I called up another broker who had given me a term sheet I didn't find quite as attractive. But at this point, beggars can't be choosers, and it looked pretty good to me now! The bank jumped at the deal and said they could close within five weeks from start to finish, and they did.*

So working with multiple lenders is key.

Just be aware that working with multiple lenders is a LOT of work because each loan officer wants slightly different information from you, or has his own forms to fill out. But it's worth it!

### Step # 3: Understand the Loan Process and Timing

The first step in the loan process is to complete a loan application and to provide preliminary information about yourself and the deal.

What you want from your loan officer as quickly as possible after you have a deal under contract is a "term sheet". A term sheet is a short one or two page letter that outlines the main terms of the loan, pending final underwriting. You can use the term sheet to compare different lenders with each other and select the best terms for you. I've found that the lenders take 1-2 weeks to produce a term sheet from the time they get the Deal Package from you.

After you receive the term sheet, the ball is in your court. The next step is for you to select your lender, which involves you ordering and paying for an appraisal. Normally the bank will require you to pay a non-refundable deposit that will cover the cost of the appraisal and maybe a few other things. The amount of this deposit is negotiable to some extent, but banks tend to be more set in their fee structures.

The appraisal typically takes 21-30 days (I still don't understand why it takes this long). Once it's completed, your loan will enter final underwriting, which takes another 1-2 weeks. The outcome of this process is a commitment letter that is a definite YES to the loan and its terms. Normally the terms are substantially the same as the term sheet, unless the underwriter discovers things about the deal she doesn't like, and adjusts the terms accordingly.

Once you receive the commitment letter from the underwriter, it takes another 14-21 days to close.

While there are always exceptions, plan for the bank to take 60 days to close once you order the appraisal. Interestingly, the time frame is about the same for a 5 unit and a 50-unit.

Let's put together a loan application package that will get your lender to say "YES!"

### Step # 4: Produce a Loan Package that will get your Lender to say "YES!"

When you first contact the lender, the first thing he'll ask for is information about the deal. He'll want the address, an income and expense report, rent roll, and unit mix.

Fortunately for you, you already have all of this information handy - in your Deal Package you already created for your investors. (see section "How to Create a Deal Package").

You will impress the socks off your loan officer when he gets this document!

He'll then most likely ask you for the following documents:

- The loan application;
- Personal Financial Statement; and
- Bank Statements.

- **Loan Application**: Each lender tends to have its own loan application, which is incredibly frustrating and time-consuming. However, a good number of them use the standard "Uniform Residential Loan Application" - see an example in the Document Library > Dealing with Lenders > Uniform Residential Loan Application.pdf.

- **Personal Financial Statement (PFS):** The PFS discloses your total net worth in terms of your assets and liabilities. The bank will require a PFS for each guarantor. I maintain my own PFS in spreadsheet form that I update every month or so. That way, it's ready to go when I need it. Even though many lenders have their own PFS form they want you to fill out, I have been very successful at referencing my PFS from the lender's PFS form: sign theirs and then write "See attached PFS" at the top. That way, they're happy you "filled out" their form but you don't have to complete 10 different PFS forms! Check out the sample Personal Financial Statement in the Document Library > Dealing with Lenders > Personal Financial Statement.xls which you can use, modify, and then print to a PDF file.

- **Bank Statements**: Most lenders will want bank statements for the last three months for every one of your bank accounts. The balances should roughly match your PFS.

Since you know there's a good chance all of your loan officers will request this information, once you prepare it for one lender, you can re-use it for the other ones without much effort.

### Step # 5: Pick The Best Term Sheet and Lender

What you seek from each loan officer as quickly as possible is a term sheet. While this is not a loan commitment, it's a strong indicator that the lender is interested in making a loan and at what terms.

Take a look at the sample term sheet in Document Library > Dealing with Lenders > Term Sheet.pdf, and let's review some of the important terms to look for.

- **Term**: "*Principal & Interest Monthly; Rate Reset in 5 years*". This means the initial term is 5 years, and then the Interest rate would reset as follows:

- **Interest Rate**: "*Fixed at 3% over 5 year Treasury with a floor of 5.25%; same pricing structure for the rate reset*". This means the initial interest rate would be 5.25% at the outset and then reset in 5 years depending on the then prevailing 5 Year Treasury.

- **Amortization**: "*25 years*". Some banks amortize the loan over 20 years. This doesn't make a huge difference in the monthly payment, but it does make a difference. Obviously the longer you have to repay the loan, the lower the monthly payments. On the other hand, the shorter the amortization, the quicker you build equity and pay off the note!

- **Prepayment Penalty**: "*The penalty shall be 3% in year one, 2% in year two, and 1 % in years three through five. Resets for subsequent 5 years. No penalty for the three months before and after the 5 year rate reset*". The prepayment penalty is relevant if you decide to sell or re-finance before the term is up. This clause is important! You should try to negotiate away any prepayment penalty. Most banks will insist on one.

You can try to minimize by having it bleed off over time (as in this example), or only apply it if you re-finance with another lender. In other words, there is no prepayment penalty when you sell or if you re-finance with the same lender.

- **Collateral**: "*First DOT and Assignment of Leases & Rents on Subject Property*". This is fairly standard. You just don't want the bank to require any additional collateral.
- **Loan-to-Value**: "*Total loan funding not to exceed the lesser of 70% of appraised market value or cost*". This is a biggy because it affects how much you need to put down. Ideally I like to put down no more than 25% for a stable property (though it may be more for a distressed asset).

The other important information to get, even though it won't be in the term sheet, is the estimated bank-related closing and processing costs and the origination fee.

Over the course of one to two weeks from when you started to "shop" the loan, you should begin to accumulate term sheets.

I then enter the most important terms in one spreadsheet so that I can compare all of the lenders side-by-side.

Check out the file in the Document Library > Dealing with Lenders > Lender Comparisons.xls. Here is a screen shot:

| | Lender # 1 | Lender # 2 | Lender # 3 |
|---|---|---|---|
| **Bank** | xxxxxxxxx | xxxxxxxxx | xxxxxxxxx |
| **Purchase Price** | $475,000 | $475,000 | $475,000 |
| **Downpayment $** | $160,000 | $118,750 | $142,500 |
| **Downpayment %** | 34% | 25% | 30% |
| **Loan Amount** | $315,000 | $356,250 | $390,000 |
| **Years Amortization** | 25 | 25 | 25 |
| **Initial Term** | 5 and 5 | 5 years only? | 25 Fixed |
| **Interest Rate** | 5.25% | 5.25% | 7.00% |
| **Comments** | | 5 Yrs Fixed, then another 5 Yrs: 10 Year Term / 25 year Amortization. Rate Adjusts for second 5 year Term @ 5 yr T-Bill + 3.50 | May be assumable subject to bank review (1%). |
| **Prepayment** | Declining prepayment penalties (3%, 2%, 1%) | 2.5% year 1, then declines by 0.5% per year only if re-fi'd thru another lender. | 2% in first 3 years |
| **Origination Charge** | 0.75% to bank, 1% to Adam, $3K deposit | 1% Origination Fee to Preferred Mortgage plus 1% Commitment Fee | 1% from bank, 1% from Gary |
| **Other Settlement Costs: appraisal, credit report** | | $495 environmental audit, require Schedule E from seller. | Credit report $10.00<br>Flood Cert. $13.00<br>Appraisal $3,000<br>Review $400<br>Const. Inspections (if any @$150/pop) |

What combination of terms are important to you will differ. For me, it was important to minimize down payment and maximize cash flow. Therefore, I favored 25% down, a longer amortization, and lower interest rates.

Based on these criteria, my first choice is Lender # 2, followed by Lender # 1.

## "But Wait! What if My Personal Financials Don't Support the Deal?"

The # 1 objection of would-be apartment investors is that they don't have any money to invest. I hope we addressed that soundly in this course because we are going to raise the money from other people.

The # 2 objection is related: "I don't have the credit, net worth or liquidity to qualify for the financing".

This is a real concern because as we discussed, banks look for a net worth at least as much as the loan amount and 10% liquidity and general credit-worthiness.

If this is an issue for you, here are a few solutions for you to consider.

### Solution # 1: Partner with Another Guarantor

One way to overcome the second objection is similar to overcoming the first: by partnering with your investors.

Since your investors have money to invest, there is a good chance their credit and personal financials are in better shape than yours.

As you reach out to your potential investors, you are not only looking for cash, you may also be looking for *guarantors.* Banks want one or more guarantors that have the net worth to cover the loan if it goes bad.

Being a guarantor doesn't cost the investor any more money, but it does increase their risk. People are willing to take on some risk as long as it's managed (i.e. minimal) and there is potential upside to make up for the additional risk.

One thing you can offer your investors in return for being a guarantor on the loan is additional equity in the deal. This means they get some additional ownership of the deal for being the guarantor on the loan. Or you can pay them a set fee at closing when you purchase the building.

What you offer the investor is obviously negotiable. You will have to ask your investor if they'd consider being a guarantor or co-guarantor on the loan in return for additional equity. And if so, what equity would they consider? Or what kind of payment would they consider?

Be aware that the bank will require a personal financial statement for each guarantor. Your investor may be uncomfortable in sharing that with you. You can address this objection by having the investor deal with the loan officer directly so that you never see the investor's financials.

### Solution # 2: Put more Money Down to get a Non-Recourse Loan

A "non-recourse" loan is a loan that is not personally guaranteed by any one person, its only collateral is the underlying asset, i.e. the apartment building. Non-recourse loans are more common as the deals get larger (typically a minimum loan amount of $1M+)

because very few individuals have the financial net worth to support such an asset themselves and banks often perceive larger assets as less risky.

Non-recourse loans on small to medium sized assets are harder to come by **unless** you put more money down. Banks normally look for a down payment of 25% to 30% of the purchase price. Banks are more likely to give you a non-recourse loan if you put more like 40-50% down.

Therefore, another solution to the personal guarantor issue is to raise more money so you can increase your down payment.

**Solution # 3: Raise more money for reserves to reduce or eliminate the bank's net worth and liquidity requirements.**

The bank has net worth and liquidity requirements because they are trying to protect themselves from the situation that you run out of money. The intent is good but can present challenges for the syndicator.

Fortunately, these requirements are not set in stone and are negotiable. The more track record you have, the more you are likely to reduce or eliminate these requirements.

If you don't have a track record, one way to negotiate these requirements is to agree to put a certain amount of reserves (like 6-9 months of interest payments) into an escrow account. You can have this "bleed off" over time, i.e. the balance may be reduced or eliminated entirely after 12 months (once the bank sees the asset and you are performing well). This addresses the bank's concerns about potentially running out of money and they may strongly consider your idea as a good alternative to your personal net worth.

This means you will have to raise more money and this would in turn reduce the investors' returns. However, if you negotiate a "bleeding off" of the reserve escrows, then that money can be returned to the investors within 12 to 18 months.

### Conclusion About What if Your Personal Financials Don't Support the Deal

The reason you're syndicating is because you don't have all of the funds yourself to purchase apartment buildings. And this does make your job more difficult than someone who has a bunch of money in a bank account themselves. However, by partnering with your investors and not only asking them for capital to invest but for other things like being a co-sponsor, we can overcome these challenges and be successful real estate entrepreneurs.

## Chapter Summary

In this chapter, we covered various creative financing techniques, including seller financing, assuming the existing financing, purchasing subject to the existing mortgage or with a master lease. We also considered crowdfunding as a viable alternative.

Despite all of these creative possibilities, the vast majority of deals are still funded with traditional financing - and why not? It's cheap and readily available, so let's take advantage of it.

We talked about working with multiple lenders and learn their underwriting requirements and loan process so that you're best prepared when you have a deal under contract. You learned about how to create a loan package that will impress the socks off the loan officer, and you learned how to read a term sheet and pick the best one.

# Chapter 9: The Home Stretch to Closing

If you made it this far, there's a good chance you're happy with the deal and want to (gulp) move forward. You've completed your due diligence and the only thing that would stand between you and closing on the deal is financing.

At this point, the risk of **not** getting the financing should be relatively low because (a) you should have a pretty good idea of the value of the building (which means you feel fairly certain it will appraise) and (b) you have at least 3 lenders you like and who gave you term sheets (as discussed in the previous chapter). This is important because if one lender falls through, you can always call the next lender in line.

In other words, the probability of closing is very good. This is important because you're about to spend real money, and if you don't close, you will not get reimbursed.

Now that the due diligence contingency has expired, you initiate the closing process. This means you'll instruct the closing attorney to start title work, order the appraisal with your lender, and pay a retainer for your attorney to draft documents.

## Initiating the Closing Process

### Step 1: Instruct the Closing Attorney to Order the Title Report

Contact the closing attorney and instruct her to begin title work and initiate the closing process. You should not incur any fees from this activity until closing.

### Step 2: Choose your Lender and Order the Appraisal

In Chapter 8 "Financing the Deal" we talked about working with multiple lenders to finance the purchase of the property. At this point, you should have received term sheets from at least three lenders and selected your favorite lender. Now it's time to reach out to that lender and give them the green light to proceed. Typically that lender will require you to make a deposit to pay for the appraisal. Go ahead and send in that check to get the ball rolling.

### Step 3: Instruct the Attorney to Create the Entity and Draft Legal Documents

Now that you know you're proceeding with the closing, it's time to create the LLC (or other entity) that will take title of the property.

You can either do this yourself, or pay your attorney to do it. If your attorney is drafting the Operating Agreement, it will only cost a little extra for him to create the LLC as well.

Once the entity is created, you'll have to craft an addendum that changes the name of the buyer to the LLC you've created. Use this kind of language:

*Buyer name shall be changed from _______________ ("Previous Buyer") to _____________________ ("Buyer"). Buyer shall have all the benefits and rights that the Previous Buyer has under this agreement. Previous Buyer shall be released from any*

*further liability hereunder and Buyer will accept all responsibilities, privileges, covenants, conditions and obligations as set forth in this entire Agreement.*

You'll likely need to pay your attorney a retainer to begin drafting your LLC operating agreement and private placement memorandum (if you have investors). Let the attorney know when your closing date is to make sure he can get the documents done in time. Typically, at this point of the process, you have about 45 days to close (the amount of time the bank normally requires from the time you order the appraisal).

Because the Operating Agreement and Private Placement Memorandum are such hefty documents, you'll spend quite a bit of time reviewing and revising them for the attorney.

## How to Handle the Closing Logistics with Your Investors

Here's how to handle the closing logistics with your investors with regards to handling the paper work and getting the funds into the escrows account.

### Step 1: Get the Investors to Review the Operating Agreement

Investors are normally busy people and won't have a ton of time or patience to read and sign a bunch of paper work.

Unfortunately, there's a ton of documents that should be reviewed by the investor and must be signed. I have found that some investors just sign when and where you want them to, some give you comments, and a few actually have their attorneys review the documents.

It is imperative throughout the entire process that you communicate clearly **what** you want done and by **when**, remind people constantly, and do whatever it takes to get it done.

Normally, the attorney will have the operating agreement ready before the PPM (since the PPM incorporates the operating agreement). The operating agreement also is the most critical document for the investor to review since it is the contract between them, you, and the LLC.

Give the investors several days to review the document and submit questions and comments. Enforce your time limits by emailing reminders and, if necessary, by calling or texting the investor.

When you email the investors to review the operating agreement, summarize the important terms of the document. Many times, this is perfectly sufficient for the investor and they might not feel the need to review the entire document. In any event, it makes it easy for the investor to say "yes" and maybe saves them time.

You want to make it as easy as possible to do business with you.

Summarize everything and provide clear instructions and deadlines.

Here's an email you can send to the investor to kick off this process.

***Subject: Apartment Building Investment - ACTION REQUIRED***

*Dear Tim,*

*I have the Operating Agreement ready for your review.* ***Can you quickly reply to let me know you got this email and attachment OK?***

*I will have the Private Placement Memorandum and Subscription Agreement ready for you by end of next week*

*The attached operating agreement serves as the contract between you, the LLC, and me. It defines what share of the LLC you're getting for your investment, your voting rights, how profits are distributed, what happens if more money is needed, or if assets or the LLC are sold or re-financed. Here are the cliff notes with regards to the more important aspects.*

*-- There are 5 investors each putting in $50K for a total of $250K. In return, the investors will receive 70% of the company. This means 70% of distributions out of cash flow.*

*-- I am the managing member and receive 30% ownership. I receive $15,000 as an acquisition fee when we close but I don't receive any additional compensation as the manager, only what comes out of profits.*

*-- Upon sale, investors receive their principal back first, then the remainder (after sales costs) is split 70/30 as well.*

*-- Upon re-finance: Investors receive 70% of any net proceeds from a re-finance (defined as any proceeds left after paying re-finance costs, returning the investors' initial investment and any capital reserves are withheld for improvements). After receiving a part or all of their principal back, investors retain their 70% ownership.*

*-- Decision-making: Members (i.e. the investors) will vote anytime a member is added or removed, if more capital is required, if their distributions are being reduced, or if the LLC is to be dissolved. Members don't get a say in operational decisions or whether the building should be sold or re-financed.*

*-- Should more cash be needed, members have the option of contributing more capital, but they are not required to do so. If someone decides not to participate, this would dilute their share accordingly.*

*-- Distributions are being made quarterly*

*INSTRUCTIONS*: ***Please read the attached operating agreement carefully, let me know if you have any questions or concerns. Sign the last page by your name. I need only the last page with your signature. I would like to get your comments by no later than next Tuesday and your signature by next Friday Dec 30. Please let me know if this timing is an issue.***

*Thanks!*

*Michael*

Make sure you get an acknowledgement that the investor has received your email. If you don't hear from them in a day, follow up via phone or text.

Send a reminder email two days before your deadline, the day before your deadline, and on the day of the deadline. If you haven't heard from the investor the day after the deadline, start to call and/or text the investor to see what's going on.

You want either an "Everything looks good" response or the investor's questions or comments. If you start getting a lot of comments, it will take more time to finalize the document. The more sophisticated your investors are, the more time this takes. Give yourself 2-3 weeks to finalize the operating agreement with your investors.

### Step 2: Get the Investors to Sign the Documents

While the investors are reviewing the operating agreement, the attorney can finish up the PPM. Then all three documents are emailed to the investors for final review and signatures. They should review the PPM but do not need to sign it. They **MUST** sign the operating agreement and the subscription agreement.

Here's the email I send to the investors.

> ***Subject: Your Signatures Required***
>
> ***Hi Tim,***
>
> [Can you please acknowledge you got and read this email, and if you can fax back signatures by this Monday? BIG HELP, Thx]
>
> *OK, now it's time to get busy. I have attached for your review and signature 3 documents. Two are GIGANTIC, and I do apologize for this; at least you know everything is done 100% right. Here's a description of each of the documents and instructions:*
>
> ***1. The Subscription Agreement (5 pages)***
>
> *DESCRIPTION: This document says that you are investing $50,000; it asks if you are an accredited investor or not; and it confirms that you received and reviewed the Operating Agreement and PPM.*
>
> *INSTRUCTIONS: Check the appropriate lines under items I, J, K, or L, and sign the last page (print name, sign, date). I need the entire document back from you.*
>
> ***2. The Operating Agreement (16 pages)***
>
> *DESCRIPTION: This is the contract between you, the LLC, and me. It defines what share of the LLC you're getting for your investment, your voting rights, how profits are distributed, what happens if more money is needed, or if the property is sold or re-financed. You already had a chance to review this document last week and I think we're all good with it.*

*INSTRUCTIONS: Please read this document carefully, let me know if you have any questions or concerns. Sign the last page. I need only the last page with your signature.*

***3. The Private Placement Memorandum (PPM) (64 pages):***

*DESCRIPTION: This contains all kinds of information and disclosures: including an overview of the business opportunity, my background, how much money is being raised, how it will be used, what the risks are, tax consequences, and SEC compliance language related to securities. It also contains nearly everything that is in the Operating Agreement.*

*INSTRUCTIONS: You can read this document but you don't necessarily need to. You do **NOT** need to sign it.*

*FINAL INSTRUCTIONS*

*I need back from you the entire Subscription Agreement and the last page of the Operating Agreement. I attached those 6 pages in a separate file called "Signature Pages.pdf" to make it easier on you. Please fax to 555-555-5555 or scan and email it back to me.*

*I NEED THESE BACK BY NO LATER THAN THIS MONDAY JANUARY 23, otherwise it will impact our closing date. If you won't be able to do this, please let me know.*

*We are targeting a closing date of February 1. I will email you wiring or delivery instructions to you next week. Funds should be at closing at least one day before.*

*Any questions or concerns, please call me at 555-555-5555.*

*... and Thanks for Participating! I'm looking forward to getting started, and doing more with you in the future!*

In addition to the three documents referenced and attached to the email, also compile just the signature pages into one PDF. This makes it easier for your investors to do business with you and to follow your instructions.

### Step 3: Ensure the Funds are Wired on Time for Closing

You're almost to the finish line! The last step is to email the wire transfer instructions to each of the investors. Give them a deadline, remind them of the deadline, and follow up if the funds aren't in the escrow account by the deadline.

As you can see, dealing with your investors can be a time-consuming process. You will find that some investors are very responsive and follow instructions, others ... well, not so much. You will need to communicate frequently and patiently, and allow extra time for the stragglers.

### What Happens Next

While you're off getting your investors to review and sign the documents, your SEC attorney is completing the necessary federal and state SEC forms, which he will file at closing. He will keep the signed documents in his files.

Now we're ready for closing!

## The Closing

This is going to be a short section. That's because the closing itself should be a "non-event" and should be over quickly.

Your closing attorney will handle all of the paper work for closing: he'll verify that the cash funds are in the escrow account, he will create the HUD-1, and manage any mortgage documents. You then go to closing, sign everything, grab the keys, and the building is yours! And if you paid yourself an acquisition fee, you'll leave closing with a nice check, too!

## Chapter Summary

In this chapter you learned about how to initiate the closing process. You instruct the closing attorney to order the title report, choose your lender and order the appraisal, and instruct the SEC attorney to the legal documents. Once the professionals are off doing their thing to prepare for closing, we can focus on the investors.

Ah yes, the investors. They're a bit like herding cats sometimes. But you're prepared to handle them just fine! You know that the investors need clear instructions and deadlines, and that you need to follow up diligently and repeatedly sometimes to get things done. You will shepherd them from review and signing all the way until their funds are in the escrow account, ready for closing.

If you followed these steps, the closing itself will be short and sweet.

Congratulations on your purchase of an apartment building by raising money from others!

Now it's time to manage the property to create maximum value in the shortest period of time.

# Chapter 10: Manage the Property To Create Value

Hiring a property manager is probably the most important hiring decision you will make. The success of the project depends on the quality of your property manager. A good manager will make your life easy … a bad one … well, not so much.

In this chapter we argue why it makes more sense to hire a property manager rather than manage the property ourselves. We'll discuss the questions to ask and what to look for in a property manager. It's important to know how to manage the property manager and what key metrics to focus on. We talk about ways we can increase the income, and therefore the value, of the property. We also discuss when it may be time to replace your property manager.

But first ...

## Should you Hire a Property Manager or Manage the Property Yourself?

You could manage your property(s) yourself - and perhaps you should - in order to learn how it works so that you can outsource it to a property manager later. Some owners who manage their own units and love it. Others have created their own property management companies.

> *I've chosen not to manage my properties because (a) I don't enjoy it that much and (b) it gives me more time to find more deals (which I do enjoy; it's also a wiser user of your time in my opinion!). Having said that, I do have some experience being a landlord and I've read books and attended seminars on the subject. I interact with my property manager at least once per week and review the monthly statements in detail.*

In any event, you should know enough to successfully manage a property manager.

What is important, in my opinion, is that you eventually stop managing your properties and hire someone else to do it. Otherwise it is sure to hold you back from doing more deals and acquiring deals. On the other hand, you could start your own property management company to manage your own units as well as others'.

Let's talk about interviewing and selecting the best management company.

## How to Select the Best Property Management Company

The property manager is the most important member of your team, even before you have your first deal under contract. He can help you during the due diligence phase with regards to rental comps, vacancy rates, and inspections, for example. Here's to find the right one.

### Step # 1: Interview the Property Manager (And What to Look For)

Here are 10 questions to ask your potential property manager and what to look for:

1. **How long have you been in business?** Always give the upstart a chance, so you might want to consider someone you like with only a year experience in the business. But in general, the longer they've been around, the better.

2. **What size of properties do you manage the most?** If you're looking to purchase a 4-plex building, don't interview a company who specializes in 100-unit buildings. Processes and procedures are totally different for these types of buildings.

3. **What are your management fees for my size building? What is your leasing fee? How else are you compensated?** Management fees generally range from 5% for larger properties to 10% for smaller properties. Leasing fees range from a half month to a full month rent. The only other type of compensation is a mark-up for repairs (typically 10%).

4. **What is your process for handling repair requests? How do tenants make requests? How quickly do you typically respond? Who does the work? What do you charge for the work?** You're looking for a well-defined process. Preferably, tenants can log in online to make the request. This gives you transparency into the process WRT response times and any communication between the tenant and property manager. The property manager should have a network of contractors to handle any repairs at the property. They typically charge 10% over and above what the contractor charges for the repair. How are emergency and non-business hour calls handled? How do they ensure that their prices continue to be competitive over time?

5. **How do you collect rents? Who keeps the late fees?** Offering automatic debit, for example, shows a higher level of sophistication than someone who collects the rents in person. Managers either keep the late fees, they're split, or they all go to you - this is negotiable, just know this upfront.

6. **What are your management policies, i.e. when and how do you handle lease violations and evictions?** You're looking for a fair and consistent process. For example, the manager might say, "the rent is considered late on the 5th day of the month, at which point I will send out a late rent letter, warning them they have until the 21st day of the month to pay, or we will start the eviction process. I then file the eviction on the 22nd day if no payment is made. I will continue to communicate with the tenant through the entire process." That is a sign of fair and consistent management policy.

7. **How many evictions have you handled and what is the cost of a typical eviction?** The more evictions, the more experience. The cost varies widely by region, so make sure you ask - update your financial analysis accordingly.

8. **What is the expected vacancy and delinquency rate for this area?** Update your financial analysis accordingly.

9. **What reports do you provide?** At a minimum, you should expect an income and expense statement and a rent roll each month - both are typical. You also want to see any delinquencies. For extra credit, you could ask for a repair and maintenance report that documents the description, cost, and turnaround time for every repair made.

10. **How do you handle the funds?** Will you get a separate bank account? This is preferable, but many property managers don't do this for properties under 25 units. The advantage of a separate account is that you can get a monthly bank statement in addition to the income/expense statement, which gives additional visibility into how your money is being handled. What reserve does he require? Typically, the manager will require a certain minimum in the bank account and will forward any excess to you.

Be sure to interview at least three property management companies.

### Step # 2: Review the Manager's Documents

At the end of you meeting, request the manager to send you a sample of his contracts (leases, late letters, etc) and accounting reports. Also request a list of references.

### Step # 3: Check References

If you like what you've heard so far, call the references. Ask these questions:

1. How pleased are you with the manager?
2. What is he doing particularly well?
3. What is one thing he could improve?
4. Why would you recommend your manager?

### Step # 4: Review the Property Management Agreement

Read the management agreement carefully, as sometimes there are clauses in there to be careful about.

> *For example, in one of my contracts it states that the property manager has 30 days to exercise a first right of refusal to purchase the property - I don't want the manager to delay a contract for that period of time.*

This is just an example, the point is, read the management contract in detail, as you should any contract.

### Next Steps

At this point, you have all the information about this property manager. Now it's time for a gut check. Sometimes a person looks good on paper but your instinct is telling you otherwise. Look at all of the PROS and CONS, but at the end of day, go with your gut.

After you give the keys to the manager after closing, the company should communicate to the tenants that there is a new manager in charge. They will likely communicate a new mailing address for the checks and they may include a new rules and regulations booklet.

Be aware that binging on a new manager may cause several tenants to stop paying their rent. My theory is that these tenants are testing the new manager to see what they can get away with. How the manager responds (quickly, consistently, and fairly) will determine the level of respect they will get with the tenants.

## Managing the Property Manager

You got into this business partly because commercial real estate is a passive investment. And this is largely true. However, there's really no investment (other than interest or dividend-bearing investments) that are truly hands-off. Nor should they be.

It's important for you to be involved enough to know what's going on, keep your team honest, and be able to make adjustments if necessary. Therefore, it's important that you **find the right balance between "hands on" and "hands off"**.

In the beginning you'll be more hands on until you and your property manager stabilize the asset and figure out how to work together.

There are three things I suggest you do on a regular basis:

1. Review the reports monthly: we'll talk more about that in a second.
2. Conduct phone calls once per week: during this call you'll review any major accomplishments or challenges that need addressing.
3. Visit the property as needed: show your face at the property as needed to see if it's being kept clean or even to get some feedback from the tenants.

Reviewing the monthly reports is so important that we'll talk more about that next.

### How to Review the Monthly Reports and What To Look For

Here are the main reports you should review each month, and what to look for.

#### *Rent Roll and Delinquency Report*

The most important thing to look for is **cash flow**. Cash flow is affected by vacancies and delinquencies. You should set realistic goals with your property manager regarding both of these keys metrics and hold them accountable for achieving them.

Here is an example of a delinquency report that shows any charges to the unit, monies collected, and outstanding balance (red box).

Dates from 5/1/2014 to 5/30/2014

| Date | Check No. | Type | Comment | Amount | Balance |
|---|---|---|---|---|---|
| Unit: 101 | | Type: 1B | | | |
| | | | | Balance Forward: | 4,975.00 |
| 5/1/2014 | | Rent Charge | | 500.00 | 5,475.00 |
| Unit: 102 | | Type: 1B | | | |
| | | | | Balance Forward: | 604.10 |
| 5/1/2014 | | Rent Charge | | 640.00 | 1,244.10 |
| 5/19/2014 | MO | Payment Received - Thank You | mo-9271 | (500.00) | 744.10 |
| 5/19/2014 | MO | Payment Received - Thank You | 9272 | (140.00) | 604.10 |
| 5/19/2014 | MO | Payment Received - Thank You | mo-9273 | (500.00) | 104.10 |
| 5/19/2014 | MO | Payment Received - Thank You | mo-9274 | (110.00) | -5.90 |
| Unit: 103 | | Type: 1B | | | |
| | | | | Balance Forward: | 2,875.00 |
| 5/1/2014 | | Rent Charge | | 430.00 | 3,305.00 |
| 5/15/2014 | ck | Payment Received - Thank You | citi 5336 | (2,745.00) | 560.00 |
| 5/15/2014 | ck | Payment Received - Thank You | citi 5337 | (555.00) | 5.00 |
| 5/15/2014 | ck | Payment Received - Thank You | citi 571 | (5.00) | 0.00 |
| Unit: 104 | | Type: 1B | | | |
| | | | | Balance Forward: | 362.50 |
| 5/1/2014 | | Rent Charge | | 725.00 | 1,087.50 |
| 5/6/2014 | ck | Payment Received - Thank You | 155 | (725.00) | 362.50 |
| 5/19/2014 | CK | Payment Received - Thank You | 156 | (181.25) | 181.25 |
| Unit: 201 | | Type: 1B | | | |
| | | | | Balance Forward: | 0.00 |
| 5/1/2014 | | Rent Charge | | 525.00 | 525.00 |
| 5/6/2014 | mo | Payment Received - Thank You | 7101 | (25.00) | 500.00 |
| 5/6/2014 | mo | Payment Received - Thank You | 7100 | (500.00) | 0.00 |

This report is so critical because it gives you a view of how your rents are being collected. The more real time this report is, the better, even though monthly is fine.

### *Cash Flow or Profit and Loss Report*

This report is fairly self-explanatory. This report shows the income and expenses and the cash balance of the account. Here is an example:

| | | % Income |
|---|---|---|
| OPERATING ACTIVITIES | | |
| INCOME | | |
| 4001 Rental Income | 11,061.25 | 92.91% |
| 4020 Subsidy Rent Charge | 844.00 | 7.09% |
| TOTAL INCOME | 11,905.25 | 100.00% |
| EXPENSE | | |
| 5017 Water And Sewer Utility | -1,423.07 | -11.95% |
| 6003 Bulk Trash | -350.00 | -2.94% |
| 6008 Common Area Cleaning | -225.00 | -1.89% |
| 6019 Labor Cost | -1,070.00 | -8.99% |
| 6023 Supplies | -225.00 | -1.89% |
| TOTAL EXPENSE | -3,293.07 | -27.66% |
| Net Income | 8,612.18 | 72.34% |
| Adjustments to reconcile Net Income to net cash provided by operations | | |
| Net cash provided by Operating Activities | 8,612.18 | |
| FINANCING ACTIVITIES | | |
| 3010 Equity Distribution | -997.49 | |
| Net cash provided by Financing Activities | -997.49 | |
| Net cash increase for period | 7,614.69 | |
| Cash at beginning of period | 1,627.49 | |
| Cash at end of period | 9,242.18 | |

While a monthly P&L is critical, it's also nice to have month-by-month side-by-side and budget vs. actual report. Your property manager's accounting system may not be able to provide that for you, and you may have to do this yourself in a spreadsheet or your own accounting software. This helps you track your actual performance versus your projected numbers.

***Expense Reports***

The expense reports should provide a summary overview and details for every expense the property manager paid for, including the amount, date, vendor, the unit number and description of the expense. It would also be nice to see the expenses for each unit.

***Work Order Report***

With this report you want to ensure that work orders are being handled in a reasonable time frame, i.e. they are rejected or taken care of. Tenants become disgruntled when they call the property manager and don't get their faucet or AC fixed quickly. Unhappy

tenants can lead to unpaid rents, unwanted turn-over or worse (lawsuits) - so make sure your property manager responds to the tenants requests promptly.

## Handling Repairs and Maintenance

The property manager will handle most repairs and maintenance for you. The larger management companies will have their own staff to handle almost anything that may need repairs, smaller companies will have a network of tradesmen to choose from.

In most cases, the property manager will charge 10% more than a 3rd party contractor. For large repairs, it is best practice for the property manager to present you with 3 bids. For smaller repairs (like turning over a unit, for example), the property manager will give you a scope of work and a cost estimate. I recommend bidding out the work to other contractors, especially in the beginning, to establish a baseline of what things cost what.

For example, your property manager may estimate it will cost $900 to replace the carpet and $1100 to paint the unit (the most common two items for getting a unit rent-ready). Get three other quotes to compare these prices to other contractors. If the property manager's prices are competitive - great! Otherwise, present the quotes you got from the other contractors to the property manager and get the manager to match the prices.

If you see the prices creep up over time, then it's time to repeat the process and get additional quotes. If the property manager cannot be competitive, you can ask them to use your contractor, or you might have to consider replacing the manager if it becomes too much of an issue.

Repairs and maintenance can quickly become a bottom-less pit, and usually the property manager profits from R&M expenses. Unfortunately, this presents a conflict of interest, and that's why it's important to stay on top of it.

## 7 Ways to Increase Income and Build the Value of your Asset

If you are able to increase income by $1000 per year (either by increasing income, reducing expenses, or a combination of both), then assuming a 10% cap rate, you are increasing the value of the building by $10,000. The more units you have, the more dramatic even a slight increase in income becomes.

Here are 7 ways you can increase the income of your asset:

### How to Decrease Your Expenses

Take a look at each expense in your profit and loss statement and determine what you can do to decrease each line item. Here is a list of suggestions:

#### *Tip # 1: Reduce your water bill*

In many cases, you (the owner) is paying for your tenant's water bill. The biggest reason the building's water bill is high is because there are leaks and drips. The best way to catch these is to encourage your tenants to report them, to look for water issues whenever the property manager enters the unit, and to do regular unit inspections.

Another way you can drastically reduce your water bill is to install low-flow toilets, faucets, and shower heads. There will be a capital expense to do so, but the break-even is several months, not years.

***Tip # 2: Reduce your heating bill***

If you're paying for heat then your heating bill will be a challenge to control. That's because your tenants will have the heat turned to full blast in the middle of winter with the windows wide open. This is why you should try to stay away from buildings where you have to pay for the heat.

A good option if you **are** paying for heat is a programmable thermostat. Even though the tenant could override the programming, most will not do so because it's too complicated to figure out. If set to EPA standards, programmable thermostats can save a significant amount of energy and costs.

***Tip # 3: Reduce your electrical bill***

Another way you can reduce your electrical bill is to replace all lighting with energy-saving bulbs.

***Tip # 4: Challenge your property tax assessment***

If you are buying a property substantially below it's tax assessed value, you should appeal the tax assessment. The process may take several months but it is worth it.

> M*y building was assessed at $650,000 and had a $5100 per year property tax bill. I purchased it for $475,000, appealed the tax assessment, and got it reduced to $525,000 and an annual tax bill of $3,800.*

***Tip # 5: Price shop your vendor contracts annually***

Each year, price shop your insurance, trash, landscaping, janitorial, and other vendor contracts to see if you can improve over the previous year.

**How To Increase Your Income**

***Tip # 6: Increase rents***

The most obvious way to increase income is to increase rents. This is sometimes easier said than done for a variety of reasons. However, you and your property manager should always be on the look-out for ways to increase rents.

If the rents in your building are below average in the area, ask yourself why that is. Perhaps the other apartment buildings are in better condition or offer better amenities.

Before you buy a building, be very clear what your business plan is to increase rents. You may decide that the exterior of the building needs work to look more appealing and more comparable to the competition. This may require the installation of awnings, a new sign, painted shutters, and improved landscaping. Sometimes even minor cosmetic improvements like this improve the curb appeal substantially and make the property more desirable.

The size of the units affect the rent. If your units are below the average size for the area, it will be tough for you to get the average market rent. If the competition has a laundry area and you don't, then this will put downward pressure on the rents as well. However, if your product at least matches that of your competition and your rents are below market, then it's time to increase rents.

If your building is in a rent-controlled area then you can't arbitrarily increase rents as you please. Rent control laws regulate exactly how much you can increase rents. Therefore, increasing rents in a rent-controlled building can take a long time, unless you rent to Section 8 / subsidized housing voucher tenants, which are exempt from rent control. The local housing authority who runs the voucher program typically pays above-market rents for their tenants, and this is a great way to increase income and reduce delinquencies.

If your building is **not** in a rent-controlled area, then you can send a rent increase notice as soon as the leases of each tenants expire. You have to consider the impact of a rent increase on turn-over expenses and vacancies, but essentially you can ask whatever you want.

Make sure you increase the rents by **something** each year so that the tenants get used to an annual rent increase, even if it's only very little.

***Tip # 7: Install laundry facilities or vending machines***

Do not underestimate the income from laundry or vending machines. Let's do some quick math on a washer and dryer:

Let's assume each unit does two loads of laundry per week. Let's assume one washer load costs $1.25 and the dryer also costs $1.25. That's $5 per week or $260 per year. At a 10-cap, you just added $2,600 of value per year. If you have 10 units then you just increased the value of your building by $26,000 just by adding laundry facilities.

In addition to increasing the income, you also added an amenity to the building, which may allow you to ask a little more in rent.

***Tip # 8: Pass on utility expenses with the RUBS system***

RUBS stands for "Ratio Utility Billing Systems" and may be appropriate for situations where the constraints of space and/or construction do not allow a property to be submetered (i.e. to have separate gas, water, or electrical meters installed for each unit). RUBS can be done for almost all utilities including water, wastewater, electric, gas and trash.

Often implementing a RUBS system requires no upfront capital investment. RUBS uses pre-calculated formulas based on industry-wide usage statistics. Once the RUBS system is in place, each tenant receives their own utility bill which they must pay.

While it may be technically feasible to use the RUBS system and pass your utility expenses to the tenants, you must first determine whether the market allows you to do so. If you're the only owner passing along the utility expenses to your tenants, and everyone else pays for water and heat, then you may have trouble filling your units or getting market-level rent!

RUBS is most appropriate when it's customary for tenants to pay for utilities but the building you purchased is not separately metered. If the market allows for it, RUBS is an excellent way to increase your income!

## When to Fire Your Property Manager

I don't like firing people. My initial approach is to try to make it work and bring out the full potential of a person. Sometimes, however, I hold on to a person for too long. I've found over the years that if I'm micro-managing someone then I have the wrong person. Micro-managing means you're telling someone exactly how you want something done rather than just agreeing on the outcome. You're repeating yourself and constantly following up. In other words, you're spending way too much time with someone to get stuff done.

Micro-managing turns you from a passive-income investor into a hands-on investors, and it's not good for you or for your property.

You and your property manager should agree about the feasibility of your business plan (whatever it is) and your property manager should be able to execute that plan without you telling him exactly how to do it. You should be able to review the key metrics and together adjust your strategy as things change.

However, if your property manager is consistently falling short of your agreed-upon goals, you find yourself micro-managing the manager, or asking for the same thing more than once, it may be time to consider a change.

Here are 5 tell-tale signs that it might be time to fire your property manager:

### Sign # 1. Not meeting target goals such as occupancy, collections, and cost control

If you and your manager agree that your vacancy should not exceed 5% per year and you shouldn't have more than 2% in uncollected rents and the manager's performance falls short, then may be time for a conversation, unless there are other factors in play that are outside the manager's control.

### Sign # 2: Lack of or Incomplete Reporting

In the section Managing the Property Manager I describe the kind of reports to look for from my property manager. Obviously before you hire the manager you need to convince yourself that the manager can give me the reports I'm looking for.

But sometimes, a person interviews better than they actually perform.

> *I had a property manager once who gave me owner reports that looked pretty good at the outset, and in truth, I didn't study them hard enough to make sure they actually did what I wanted them to. Once we got started, I found myself asking the manager for things like outstanding rent balances by unit or for more explanation of expenses. Because his reporting was not adequate to answer my (what I thought were routine) questions, he had to research these questions and it frustrated him as well as me. Because this manager was managing primarily*

> *smaller buildings, my sense was that his other clients were not as demanding as I was, and that incompatibility became more and more stressful.*

Make really sure that the property manager is putting out reports that give you the answers you need without a whole lot of follow-up. If you're constantly asking for more information because of incomplete or missing reporting, then this is a sign that the relationship could be short-lived.

### Sign # 3: Ignorance, Inexperience or Incompetence

This sounds obvious, but many times you can't tell that your property manager is ignorant or incompetent until you've been working together for a while.

> *I was dealing with a difficult situation that involved landlord-tenant issues as well as housing code compliance issues. While my property manager appeared to be knowledgeable at the time (at least compared to me), it eventually became obvious that the manager's inexperience cost me thousands of dollars.*
>
> *In addition, I listened to bad advice with regards to renting to Section 8 subsidized housing tenants. The property manager was opposed to the idea. I now understand this was because he was inexperienced with dealing with section 8 tenants, and he therefore advised against it. After replacing the manager, my new property management company specialized in section 8 tenants, and subsidized housing is* ***the*** *strategy for the part of the city the building is in. It as a major mistake* ***not*** *to rent to section 8 tenants right from the start, a mistake which also cost me thousands of dollars.*

What you don't know can cost you and sometimes you can't prevent that. But when you **do** learn something that requires a change and then you don't take action, then that's an avoidable mistake!

### Sign # 4: They Don't Do What They Say They're Going to do

I expect people to do what they say they're going to do or communicate otherwise. That's it. No more, no less.

I can't stand it when someone tells me "I'll email this or that to you by the end of the day", and the end of the day comes and goes and I get no other communication. The more this goes on, the more aggravated I get, and the more of a red flag it becomes.

But maybe that's just me ...

### Sign # 5: Lack of Owner Mindset

Signs # 1 through # 4 could be boiled down to one thing: your property manager does not have an owner mindset. While no one is going to care as much about your asset as you do, you want your manager to care about it **almost** as much. You want that manager to behave as if it's their own building.

You could argue that it's not ideal that the property manager owns his own apartment buildings (because they're more likely going to compete with you to acquire additional

buildings, and that makes it more difficult to involve them upfront as you evaluate opportunities), I do prefer that they do own their own multi-family buildings. They generally use the same people and systems for your buildings as their own.

You don't want your property manager just to meet expectations, you want them to continually push the envelope with the property. You want them out there coming up with new ideas of how to increase income and reduce expenses. You want them to continually improve their own systems and how they do things.

If you don't see your property manager aggressively and proactively managing the property it should raise a red flag.

### Conclusion About When to Fire Your Property Manager

It's short-sighted to fire your property manager for just one of these infractions (though you certainly could). But the more of these signs you see the more likely it may be time for you to re-evaluate your relationship with them.

If you're frustrated with dealing with your manager, not achieving your business plan, and spending way too much time "managing" the manager, it may be time to pull the plug on your property manager.

On the other hand, working with a property management company that performs at the highest level makes the process easier and even fun. You'll have more time to enjoy life and possibly look for more units rather than worrying about the ones you already have.

## Chapter Summary

In this chapter we made the argument that it makes more sense to ultimately higher a property manager, and we talked about the questions to ask and how to select the best one. It's then important to interact regularly with the manager, review the key metrics and make adjustments as necessary. We discussed ways we can increase the income and value of the asset. Despite our best efforts, the property management company we chose doesn't work out, and we talked about several signs to look for that might indicate it's time to part ways.

The goal of this chapter is to help you hire the best property management company and manage the property to maximize its value in the shortest period of time possible.

# Chapter 11: Exit Strategies for Maximum Profits

You should be clear **when you buy the apartment building** what your desired exit strategy will be. Don't just buy a property and hope for the best. Be intentional about your plans and have the end in mind.

In this chapter, we'll discuss the following exit strategies using the case study of the 12-unit building we've been using throughout.

1. Traditional Buy and Hold;
2. Flip the property;
3. Cash-Out Refinance, Hold, and Sell For Maximum Value Creation; and
4. Trade Up with a 1031 Tax Deferred Exchanges

We'll also discuss tips for getting your property ready for sale.

## Quick Review of the Value-Add Case Study

Here is the Summary tab of the Syndicated Deal Analyzer from where we left it at the end of Week 3 of Due Diligence:

| PURCHASE | | |
|---|---|---|
| # Units | 12 | |
| Asking Price | $515,000 | |
| Purchase Price | $475,000 | |
| Price Per Unit | $39,583 | |
| Earnest Money Depost (EMD) | $4,750 | 1% |
| Down Payment | $142,500 | 30% |
| 1st Mortgage | $332,500 | |
| Interest Rate | 6.00% | |
| Term / Amortization | 25 | |
| 2nd Mortgage | $0 | |
| Interest Rate | 5.25% | |
| Term / Amortization | 10 | |
| Closing Costs | $38,795 | 8.2% |
| Acquisition Fee | $14,250 | 3.0% |
| Repairs | $32,000 | |
| Total Member Capital Needed to Close | $227,545 | |
| Cap Rate at Re-Sale | 8.00% | |
| **INCOME & EXPENSES (Year 1)** | | |
| Gross Scheduled Income | $85,740 | |
| - Vacancy | ($8,574) | 10% |
| - Concessions, Loss to Lease, Bad Debt | $0 | 0% |
| = Effective Rental Income | $77,166 | |
| + Other Income | $0 | |
| Gross Operating Income | $77,166 | |
| Expenses | $43,213 | 56% |
| Net Operating Income | $33,953 | |
| Debt Service | $25,708 | |
| Cash Flow After Debt Service | $8,245 | |
| **KEY INDICATORS** | | |
| Cap Rate | 7.15% | |
| Cash on Cash Return | 3.62% | |
| Debt Coverage Ratio | 1.32 | |
| Gross Rent Multiplier | 5.54 | |
| **INVESTOR RETURNS** | | |
| Member Equity | 60% | |
| Manager Equity | 40% | |
| Preferred Return to Members | 5.0% | |
| Asset Mgt Fee to Manager | 0% | |
| Capital Transaction Fee to Mgr | 1% | |
| Cash Flow to Members (Year 1) | $8,245 | |
| Member Cash on Cash Return (Year 1) | 3.62% | |
| Average Annual Return ........................ | 14.68% | |
| IRR | 12.75% | |

If you recall, our business called for an increase in rents from $595 currently to $750 after 3 years. During the same time, we felt we could reduce expenses from 56% to 45%.

Let's look at the first strategy, which is to hold the asset and sell in 5 or 10 years.

## Strategy # 1: Traditional Buy and Hold

The default assumption so far has been that we are selling the building in 5 years - that's the default scenario in the Syndicated Deal Analyzer. As we've discussed, selling after 5 years yields about a 15% average annual return for the investors.

Let's take a first look at the tab "Exit Strategies" to see how the proceeds from a sale are calculated.

**Disposition End of Year → 5**

| | | |
|---|---|---|
| Net Operating Income | | $56,716 |
| Cap Rate | | 8.00% |
| Sales Price | | $708,946 |
| Sales Cost | 6.5% | ($46,082) |
| Outstanding Loan Balance | | ($299,024) |
| Total Equity | | $363,841 |
| Return of Member Capital | | $227,545 |
| Net Proceeds/Profit from Sale | | $136,296 |
| Principal Reduction | | $33,476 |
| Appreciation | | $102,820 |
| Capital Transaction Fee to Mgr | 1% | $7,089 |
| Net Proceeds/Profit Paid to Members | 60% | $77,524 |
| Net Proceeds/Profit Paid to Manager | 40% | $51,683 |
| **Total Cash to Members at Sale** | | **$305,069** |

**After Final Disposition**

| | |
|---|---|
| Total Profits from Appreciation Paid to Members | $77,524 |
| Total Cash to Members (Initial Capital + Profits from Appreciation) | $305,069 |

In Year 5 the Net Operating Income (from the "P&L" tab) is $56,716. At a projected cap rate of 8.0%, we expect the sales price to be $708,946 (we bought it at $475,000!). After paying an estimated 6.5% of sales and closing costs and repaying the outstanding loan balance, we have $363,841 (the "Total Equity"). Our investors (members) get their invested capital back, leaving us with a total of $136,296 of Net Proceeds from the sale. 60% of that is paid to our investors, and we get the other 40%.

**What would be the returns if we held the property for ten years?**

To find out, go to the "Exit Strategies" tab, and in the upper left hand corner change the " Sale / Disposition at End of Year" field from 5 years ...

| Exit Strategy | Year |
|---|---|
| Cash Out Re-Finance Beginning of Year → | NA |
| Sale / Disposition at End of Year → | 5 |

... to 10 years:

| Exit Strategy | Year |
|---|---|
| Cash Out Re-Finance Beginning of Year → | NA |
| Sale / Disposition at End of Year → | 10 |

This changes the returns from ...

| | |
|---|---|
| Average Annual Return ........................ | 14.68% |
| IRR | 12.75% |

... to:

| | |
|---|---|
| Average Annual Return ........................ | 17.08% |
| IRR | 12.89% |

The average annual return is a little higher because we're giving the property longer to appreciate. The IRR is about the same because it's also taking longer to get that same return (the IRR takes into consideration the value of time - more on this later!)

### Conclusion about the Buy and Hold Strategy

The Buy and Hold strategy is the simplest of all strategies because once you stabilize the property (if necessary), you simply let your property manager do their job - classic passive income!

While the Buy and Hold strategy is the ultimate passive income generator, it's not the one that yields the highest returns. If you're willing to do a little bit more work, then let's consider the next two strategies: flipping the property and doing a cash-out refinance.

## Strategy # 2: Flip the Property

There are at least three different kinds of flips.

### Flip # 1: Wholesaling

There's the "**wholesale flip**", in which you get a building under contract and then assign the contract to the ultimate buyer for a fee. I bought the 12-unit in this way.

While wholesaling is a strategy, it's not the kind of strategy I'm describing or advocating here. I'm looking to build long-term wealth, not selling the purchase contract for a quick profit.

### Flip # 2: Back-Flipping

Another kind of flip is the "**back-flip**" (coined by Peter Conti), which involves purchasing the note of a property in distress at a discount. You purchase the note at a discount off the currently appraised value and own the building for a short while. Within a few

months, you then sell the building back to its original owner for a profit. The owner is happy because he still owns the building and has reduced his debt, the bank is happy because it has the bad asset off its books, and you're happy because you got paid!

Kind of a cool strategy, but again, not something I'm looking for.

### Flip # 3: Stabilize and Flip

Then there's the "**stabilize and flip**" strategy, which involves re-positioning a property and then selling it once it's stabilized. For example, you might buy a vacant building, renovate it, and once it's fully leased, sell it for a profit.

The two potential benefits of this strategy are (1) higher returns and (2) an early return of capital. Let's see if any of them apply to our case study.

#### *Benefit # 1: Higher Returns*

Back to our example. Let's assume we want to flip this property once it's stabilized, which in our case is after Year 3, the year after which we think we will have optimized the property.

To model this scenario, go to the "Exit Strategies" tab in the Syndicated Deal Analyzer. Change the Year of Sale from the default Year 5 ...

| Exit Strategy | Year |
|---|---|
| Cash Out Re-Finance Beginning of Year → | NA |
| Sale / Disposition at End of Year → | 5 |

... to Year 3:

| Exit Strategy | Year |
|---|---|
| Cash Out Re-Finance Beginning of Year → | NA |
| Sale / Disposition at End of Year → | 3 |

Take a look at the returns in the Summary tab:

| | |
|---|---|
| Average Annual Return ...................... | 13.24% |
| IRR | 12.26% |

It appears that "flipping" this building after three years does not produce better returns overall.

If you were able to add more value faster, the flip might produce better returns. For example, if you purchased a half empty or completely vacant building, made substantial renovations and leased up the building, then you would have created massive value. If you model that with the Syndicated Deal Analyzer, the returns are likely to be much better than the traditional buy and hold.

But at least you know how to model this scenario now!

***Benefit # 2: Early Return of Capital Means Less Risk for Investors and No Need to Raise More Cash***

While sometimes the returns of a flip can be higher than a 5 or 10-year hold, the other advantage of flipping commercial property is that it frees up capital sooner than locking it up for 5+ years. This reduces the risk for your investors because they get their capital back sooner. Anytime an investor gets their capital back, the risk is off the table.

Another positive side effect of returning capital early is that your investors are likely to reinvest their capital with you so you can do another deal without having to raise additional cash. In fact, if you can purchase **two** value-add deals in 5 years (and flip each in two and a half years), your overall returns over that time frame will be **substantially** higher than holding just one value-add deal over the same period of time.

### Conclusion of the Flipping Strategy

The primary drawback of flipping commercial property is that it's more work than any of the other strategies. While it's true that you can achieve higher returns, you're either constantly renovating properties, looking for another deal or trying to sell something. If you're looking for more passive income, then flipping may not be the strategy for you. On the other hand, if you're seeking maximum returns for your value-added deal, then flipping may be the way to go!

## Strategy # 3: Cash-Out Refinance, Hold, and Sell For Maximum Value Creation

If we are able to add substantial value to the building by increasing the net operating income, then the "Cash-Out Refinance" strategy is the most exciting strategy of them all. A prudent refinance allows us to boost our investors' return and return part or all of their capital in a relatively short period of time so that we can use the same capital again for another deal **AND** we continue to hold the asset long term - the best of both worlds.

Let's re-visit at our example. Instead of holding the property for five years or flipping it in two, we want to see the impact on our returns if we re-financed after we stabilized the property (beginning of year 4), then held the property for another 5 years.

### How to Model the Cash-Out Refinance Strategy

To model this scenario, we go back to the "Exit Strategies" tab and under "Exit Strategy", set "Cash Out Re-Finance **Beginning** of Year" to "4" and "Sale / Disposition at **End** of Year" to "8".

| Exit Strategy | Year |
|---|---|
| Cash Out Re-Finance Beginning of Year → | 4 |
| Sale / Disposition at End of Year → | 8 |

Now look just under this and you'll see this table where it says "Refinance Beginning of Year":

**Refinance Beginning of Year → 4**

| | | |
|---|---|---|
| Net Operating Income | | $55,064 |
| Cap Rate at Re-Finance | | 8.00% |
| Appraised Value | | $688,298 |
| Re-Finance LTV | | 80% |
| Interest Rate | | 6.0% |
| Term / Amortization (Years) | | 25 |
| Re-Finance Loan Amount | | $550,638 |
| - Re-Finance Costs | 2.5% | ($17,207) |
| - Repay Outstanding Loan Balance | | ($313,626) |
| = Gross Proceeds from Re-Finance | | $219,804 |
| Return of Member Capital | | $219,804 |
| Capital Account Balance After Re-Fi | | $7,740 |
| Net Proceeds/Profit from Re-Finance | | $0 |
| Principal Reduction | | $18,874 |
| Appreciation | | $0 |
| Capital Transaction Fee to Mgr | 1% | $0 |
| Net Proceeds/Profit Paid to Members | 60% | $0 |
| Net Proceeds/Profit Paid to Manager | 40% | $0 |
| **Total Cash to Members at Re-Finance (Initial Capital + Appreciation)** | | **$219,804** |
| Ending Capital Account Balance | | $7,740 |

This section calculates the proceeds and impact of a cash-out refinance. Assuming that the new bank gives you a loan of 80% of the appraised and you pay 2.5% in closing costs, you will be able to repay the previous outstanding loan balance as well as **MOST** of the investors' invested cash (all except $7,740).

### Understanding the Returns of the Cash-Out Refinance Scenario

If you check out the "Summary" tab, then this refinance changes our returns from the standard 5-year hold from ...

| | |
|---|---|
| Average Annual Return ........................ | 14.68% |
| IRR | 12.75% |

... to:

| INVESTOR RETURNS | |
|---|---|
| Member Equity | 60% |
| Manager Equity | 40% |
| Preferred Return to Members | 5.0% |
| Asset Mgt Fee to Manager | 0% |
| Capital Transaction Fee to Mgr | 1% |
| Cash Flow to Members (Year 1) | $8,245 |
| Member Cash on Cash Return (Year 1) | [illegible] |
| Average Annual Return ........................ (Until All Member Capital is Returned) | 363.78% |
| IRR | 14.79% |

**NOTE:**
Refinance in Year 4 Returns Part or All Member Capital.
The Average Annual Return is measured only until ALL member capital is returned.
Use IRR for a more accurate measure of return in the case of a Refinance.

You'll notice two things:

1. The Average Annual Return increases to a seemingly unacceptably high level; and
2. The IRR jumps dramatically to almost 15% (up from about 13%).

To understand why, let's first look at the "Returns" tab.

**Summary of Projected Member Cash Flows and Returns**

| | 1 | 2 | 3 | 4 (REFINANCE!) | 5 | 6 | 7 | 8 (SALE!) | Return $ | Return % |
|---|---|---|---|---|---|---|---|---|---|---|
| Beginning Member Capital Account Balance | $227,545 | $227,545 | $227,545 | $227,545 | $7,740 | $7,740 | $7,740 | $7,740 | | |
| Member Cashflow | $8,245 | $14,776 | $21,202 | $12,045 | $8,640 | $9,661 | $10,713 | $11,796 | $97,079 | |
| Cash on Cash Return | 3.62% | 6.49% | 9.32% | 5.29% | 111.63% | 124.82% | 138.40% | 152.39% | | |
| Net Proceeds/Profits from Refinance or Sale | | | | $0 | | | | $128,186 | $128,186 | |
| Average Annual Return to Date | 3.62% | 5.06% | 6.48% | 6.18% | 167.72% | 160.57% | 157.40% | 363.78% | | |
| Return of Member Capital | | | | $219,804 | | | | $7,740 | | |
| Ending Member Capital Account Balance | $227,545 | $227,545 | $227,545 | $7,740 | $7,740 | $7,740 | $7,740 | $0 | | |
| Total Return in Investment | | | | | | | | | $225,265 | 99.00% |
| Average Annual Return Until Return of all Member Capital | | | | | | | | | | 363.78% |
| IRR | | | | | | | | | | 14.79% |

The top section of this tab (under "Summary of Projected Member Cash Flows and Returns") shows you how the Average Annual Return is calculated. In general, the Average Annual Returns is the Member Cashflow divided by the Member Capital Account Balance (i.e. how much cash the investors have in the deal).

While this metric is great for measuring a simple buy and hold investment, it falls short for a refinance scenario. That's because a cash-out refinance returns SOME or ALL of the investors' capital. If the investors have ZERO cash in the deal, then their average annual return is actually INFINITY, which is what the "Returns" tab displays if that's the case. If, like in this case, the investors are repaid the MAJORITY of their capital (all but $7,740), then the average annual return increases so much as to also be meaningless.

This makes the Average Annual Return rather meaningless in a refinance scenario.

One way you could articulate this to your investor is to say "your average annual return will be about 8.5% until you get your capital back in two years. Then your risk is off the table and technically your cash on cash return is infinite. Actually, you'll continue getting 60% of any distributions and profits from the sale after year 8."

### Using the Internal Rate of Return (IRR)

Up until now, we've glossed over this thing called the "Internal Rate of Return" (IRR) because it's a more complex financial concept that usually only confuses the average investor. Because of that, I advise that syndicators focus more on the simpler average annual return.

However, as we've seen with the refinance scenario, in which part or all of the investors' capital is returned, the annual average return is no longer useful in measuring the return of the investor.

Instead, we have to start using the IRR to compare one scenario with another. The IRR is better at calculating the return of a financial investment of **ANY** kind and variety, making it the best apples to apples comparison between investments.

One of the benefits of IRR is that it incorporates the impact of time on value and also accommodates the return or addition of capital to the investment.

Rather than boring you with the theory of how the IRR works, let's just look at a real live example. Go to the "IRR" tab of the Syndicated Deal Analyzer for the scenario we're modeling:

| 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|
| Year | Member Contribution | Cash Flow Distribution | Proceeds from Refinance or Sale | Total |
| 0 | ($227,545) | $0 | | ($227,545) |
| 1 | | $8,245 | | $8,245 |
| 2 | | $14,776 | | $14,776 |
| 3 | | $21,202 | | $21,202 |
| 4 | | $12,045 | $219,804 | $231,849 |
| 5 | | $8,640 | | $8,640 |
| 6 | | $9,661 | | $9,661 |
| 7 | | $10,713 | | $10,713 |
| 8 | | $11,796 | $135,926 | $147,722 |
| 9 | | $0 | | $0 |
| 10 | | $0 | | $0 |
| Total | ($227,545) | $97,079 | $355,730 | $225,265 |
| IRR | | | | 14.79% |

The IRR is a formula in Excel that takes as its input a series of cash flows in and out to calculate its result.

Any cash that is invested, such as the Member Contribution in column 2, is a negative number and is counted into the investment in Year 0 (i.e. at the outset of the investment). Subsequent cash that the investment returns back to the investors is depicted as positive numbers. This consists of cash flow distributions (column 3) as well as any cash returned from a refinance and/or sale (column 4).

Once the in- and outflow of cash is in a column (like column 5), you apply the IRR function to the series and it will calculate the resulting return.

The IRR is the **only way** to compare any of these exit strategies side-by-side, or to compare this kind of investment (i.e. apartment buildings) with any other kind of investment (such as a restaurant or other business). It's the great investor return equalizer!

While I down play the IRR, your more sophisticated investors will know EXACTLY what it is. For your less sophisticated investors, you can position the IRR as the "new average annual return" when it comes to a refinance scenario. While this isn't entirely accurate, it does preserve the intent of the average annual return, which is to measure the return on one's capital over a period of time.

### A Great Way To Own the Majority of the Building

The Cash-Out Refinance is also a good way to "buy out" the investors' preferred rate of return. This is the one and only argument from your perspective for having a preferred rate of return.

Let's say you give the investors a hefty 8% preferred rate of return. Because the return is so high, you give them only 25% equity so that they can participate in a small upside if there is any. Investors are normally thrilled with this combination because a good portion of their return is "guaranteed" (well, it's not guaranteed, but it's perceived as such because they are the first to get paid) and they get a little bit of the upside potential.

Let's model these two scenarios with the Syndicated Deal Analyzer.

***Give the Investors a Preferred Return To Boost Your Overall Payout***

Go to the "Summary" tab, scroll to the bottom, and change the preferred rate of return and equity for the Members like this:

| INVESTOR RETURNS | |
|---|---|
| Member Equity | 70% |
| Manager Equity | 30% |
| Preferred Return to Members | 0.0% |

The returns are now:

| | |
|---|---|
| Average Annual Return ...................... | 391.31% |
| (Until All Member Capital is Returned) | |
| IRR | 15.02% |

Let's look at the "Returns" tab to see what **our** (the syndicator's) expected cash flow distributions and profits will be based on our current assumptions.

Summary of Projected Manager Cash Flows and Returns

| | 1 | 2 | 3 | 4 (REFINANCE!) | 5 | 6 | 7 | 8 (SALE!) | TOTAL |
|---|---|---|---|---|---|---|---|---|---|
| Manager Cashflow (Acquisition Fee + Equity + Asset Mgmt Fee) | $16,724 | $5,113 | $8,326 | $3,747 | $4,243 | $4,753 | $5,279 | $5,820 | $54,005 |
| Capital Transaction Fee to Mgr | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $7,747 | $7,747 |
| Net Proceeds/Profits from Refinance or Sale | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $64,093 | $64,093 |
| Total Payments / Profits / Distributions | $16,724 | $5,113 | $8,326 | $3,747 | $4,243 | $4,753 | $5,279 | $77,660 | $125,844 |

Now, go back to the "Summary" tab and give the investors an 8% return but only 25% equity:

| INVESTOR RETURNS | |
|---|---|
| Member Equity | 25% |
| Manager Equity | 75% |
| Preferred Return to Members | 8.0% |
| Asset Mgt Fee to Manager | 0% |
| Capital Transaction Fee to Mgr | 1% |
| Cash Flow to Members (Year 1) | $8,245 |
| Member Cash on Cash Return (Year 1) | 3.62% |
| Average Annual Return ...................... | 210.56% |
| (Until All Member Capital is Returned) | |
| IRR | 10.74% |

You'll see that this reduces the IRR for the investors quite a bit.

The more dramatic difference is to your returns (look back at the "Returns" tab):

**Summary of Projected Manager Cash Flows and Returns**

| | | | | REFINANCE! | | | | SALE! | |
|---|---|---|---|---|---|---|---|---|---|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | TOTAL |
| Manager Cashflow (Acquisition Fee + Equity + Asset Mgmt Fee) | $14,250 | $0 | $7,162 | $0 | $10,142 | $11,419 | $12,733 | $14,087 | $69,792 |
| Capital Transaction Fee to Mgr | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $7,747 | $7,747 |
| Net Proceeds/Profits from Refinance or Sale | $0 | $0 | $0 | $0 | $0 | $0 | $0 | $160,232 | $160,232 |
| **Total Payments / Profits / Distributions** | **$14,250** | | **$7,162** | | **$10,142** | **$11,419** | **$12,733** | **$182,066** | **$237,771** |

You'll notice three things:

1. The cash flow **before** the refinance is considerably less, almost miniscule. That's because you have to pay out 8% of the invested capital **first** before you get paid anything.

2. The cash flow distributions to you **after** the refinance jump considerably. That's because after you repaid the investors' most or all of their initial investment, the hefty 8% preferred rate of return payment is gone, and you get 75% of any distributions, which means you get the vast majority. This is fair, because you eliminated the investor's risk completely because they got their principal back.

3. Your net proceeds from the final sale are considerably higher. That's because you own 75% of the building!

If you're contemplating a cash-out refinance, then you might want to consider a high preferred rate of return with a small amount of equity for your investors. That does mean that you will hardly get paid anything in the beginning, but when you return your investors' initial capital, you will own the majority of the building and your returns will be much more significant.

### Conclusion of the Cash-Out Refinance Strategy

The Cash-Out Refinance Strategy is a great way to boost returns, return capital to the investors AND hold on to the asset, building long-term wealth. Because you're returning capital early, you don't need to raise additional cash to do more deals, and your investors' risk is off the table. It's also a great way to combine this strategy with a preferred-rate of return for your investors so that you end up with a majority of ownership once the capital is returned.

In my opinion, the Cash-Out Refinance Strategy gives you the optimal mix of benefits, making it the best of the 3 strategies!

## Strategy # 4: Trade Up with a 1031 Tax Deferred Exchange

When you sell a building and there’s a profit from the sale, that profit is taxable, typically at the capital gains tax rate (even though the gain from depreciation is taxed higher). I’m not a tax expert and I don’t pretend to be one, but suffice it to say, you pay taxes on your gains.

A 1031 Exchange allows you to defer any taxes that may be due from the sale of a building if you buy another (larger) building within a certain time frame. The exchange allows you to sell a smaller building tax-deferred and use the proceeds to purchase a larger building. This strategy accelerates the wealth-building process significantly

because you're not having to pay taxes out of your gains; therefore, you have more capital to work with.

I have not used the 1031 Exchange myself (yet) but I'll share with you what I know about it because it's good to have in your tool box when it's time to sell your asset.

The 1031 Exchange has two requirements: (1) the property you're considering trading up to has to be equal to or greater in value than the one you're selling and (2) the proceeds from a sale must go through a Qualified Intermediary and not through your own hands.

There are two important timelines to adhere to: (1) the Identification Period and (2) the Exchange Period. The Identification Period is no more than 45 days, during which you have to identify one or more properties to buy. The Exchange Period ends 180 days after you sell the first property, and during this time you just have closed on the new property. Neither of these time periods can be extended, and violation thereof breaks the rules of the 1031 Exchange and regular capital gains taxes apply.

Hope that helps!

## Preparing Your Property for Sale

When it's time to sell the property, you want to put your best foot forward. This means making your property look the best it can and preparing all of your documentation to facilitate a potential buyer's due diligence process.

Make sure the property shows well. First impression is everything:

- Cut the grass, trim bushes, apply mulch
- Clean up any trash or debris around the building.
- Fix any cracks in the concrete or paving.
- Paint anything that needs paint. Paint is cheap but makes everything look much better.
- Evaluate the interior common areas and the units you want to show. Make them shine.

Check everything by pretending you're a buyer. Pull up to the property, park, and walk into the building. What's your impression? Is there anything else that needs to be done to improve the curb appeal? What about the inside of the building and the model units?

Next, prepare all of the documents the buyer will likely request for due diligence. Most sellers just don't have their documents in the order - don't be that seller! For a list of documents to prepare, see Chapter 7 "Perform Due Diligence to Avoid Mistakes". Also be sure you're compliant with all city ordinances. If you're in a rent controlled-area, make sure your rent registrations are current. Make sure you have your lead paint documents in area.

You will stand out from most other sellers, and your transaction will be faster and smoother if your documents are in order.

## How to Sell your Property

You can certainly sell your own property or use your buddy who helped you buy the house you live in, but there's a good chance you won't be playing with a full deck of cards.

That's because commercial real estate (CRE) agents, especially those with a CCIM designation, are more qualified and will do a better job for you. The good CRE agents maintain their own list of buyers and do their own marketing (online and direct mail) to get as many eye balls on your property as possible.

As you evaluate potential brokers, make sure they specialize in the type of asset you have and in the area you're in. Ask them about their annual volume - you're looking for someone who has good deal flow. Ask them how they market, and how many buyers they have on their buyer's list.

A good CRE agent will also prepare a professional-looking property package. Take a look at a Marcus & Millichap sales package to get an idea of what I'm referring to. These things look great and contain an executive summary, financials (actuals, ProForma, and projections), rent roll, rental and sales comps.

A good CRE agent will have the deal experience to handle all necessary paperwork and overcome any challenges that may come up during the sales process.

Bottom-line: get the best CRE agent you can find because they'll get you the best deal and make the process as smooth as possible.

## Chapter Summary

In this chapter we discussed the following exit strategies:

1. Traditional Buy and Hold;
2. Flip the property;
3. Cash-Out Refinance, Hold, and Sell For Maximum Value Creation; and
4. Trade Up with a 1031 Tax Deferred Exchanges

We talked about the pros and cons of each and compared them by modeling them with the Syndicated Deal Analyzer. I think the best combination of passive income and maximum value creation is the Cash-Out Refinance strategy, as long as you're able to create enough value to refinance out comfortably. We ended the chapter by discussing tips to get your property ready for sale.

Hopefully in this chapter you have some options available to you as you consider an exit strategy, know some of the pros and cons for each, and know how to model it with the Syndicated Deal Analyzer.

# Next Steps

WOW, we have really covered a lot of ground in this course. I applaud you for sticking with it, that is truly outstanding. Here's a quick summary of we discussed and some suggestions to what to do next.

- How To Raise Money from Private Individuals
- Select the Right Area in which to Invest (Even Out of Area)
- How to Find Deals
- How to Build an A-Team
- How to Analyze the Deal
- Make and Negotiate Offers
- Perform Due Diligence
- The Closing Process
- Finance the Deal
- Manage the Property for Maximum Profits.
- Exit Strategies

My goal with this course is to arm you with the knowledge and tools to give you the confidence to go out, raise money, make offers, and do deals. I hope I've accomplished that goal.

**One thing I can't do for you is to TAKE ACTION - that's one thing you need to do for yourself.**

Don't be overwhelmed by the task at hand. Don't think through the 100+ things that need to happen for you to get into your next deal. Don't do that. Instead, write down the next 3 things you know you need to do next. Do those three, then write down and do the next 3 things. Imagine if you continue this for two months where you will be. You will be amazed.

I would love to hear from you and about your journey. Make sure you touch base every once in a while on www.TheMichaelBlank.com/contact or post a comment on one of the posts or podcasts.

I hope you enjoyed this course as much as I enjoyed making it. I wish you all the best life has to offer you.

Michael Blank

## About Michael

My passion is being an entrepreneur and helping others become (better) entrepreneurs.

I helped start a software company that eventually went public. I flip houses, own commercial real estate and operate pizza restaurants. I enjoy starting and growing companies, I love making sense of chaos and taking calculated risks. I especially enjoy the "art of the deal": raising private money and putting deals together.

I enjoy in equal measure teaching. I have taught computer science courses, financial literacy classes to adults and children, and courses on how to buy apartment buildings. Because of my experiences as an entrepreneur in different businesses, I feel I can help others gain the knowledge and confidence to take the first steps as an entrepreneur, or to become better at what you're already doing as an entrepreneur.

If you care to read on, here is more about my story.

I'm an entrepreneur at heart, but it took me a while for me to figure that out.

I have a computer science degree and after several years of working for larger companies (including AOL) I took the leap and joined a software startup called webMethods. We started by developing software products that sold for $100's per license and later sold sophisticated business integration software that sold for millions. We went from a group of three out of our CEO's basement to 1,300 employees worldwide. WebMethods had one of the most successful IPO's in 2001.

Because we were growing so quickly, I spent very little time programming software and most of my time interviewing and managing people. I had a development team in California as well as in Virginia. I spent six months in Germany developing a product with a partner.

After about four years, I felt like I wanted to start and run my own software company one day, but I only had experience with software development. I wanted to learn marketing and sales. I convinced my CEO to support my experiment, and so I spent the next two years in marketing, dreaming up and executing innovative lead generation programs.

I then convinced our President to let me try my hand at actually selling software. I read every sales book I could get my hands on and attended a high-tech sales boot camp. I then created a target list and started hitting the phones. By the time I left a year later, I had sold $50,000 of software and had a $400,000 pipeline. It was the hardest job I have ever had, but I learned stuff about selling I still use to this day.

By this point, the culture of the company had changed radically from the good ol' start up days, and I felt my excitement waning. After 8 awesome years, I parted ways with an experience I will never forget.

I took some time off to travel with my wife, and when I came back, I networked with venture capitalists and software entrepreneurs, searching for that next software product to bring to market.

Despite my best efforts, I just couldn't find anything that excited me.

As they say, when one door closes, another one opens.

I read the book "Rich Dad Poor Dad" and I was like, "Man, where has this been all my life?! Passive income is what I need, not money in the bank!"

So I abandoned my plans for the next software IPO and decided to pursue "passive income" through real estate and the restaurant business.

On the real estate side, I decided to flip houses. I read books and signed up with a local mentor. From my first direct mail campaign, I purchased two properties that I rehabbed and sold for a $110,000 profit. After doing a few more deals, I took a couple years off because I was getting busy with the pizza restaurants. I things settled down a bit, I rehabbed 30 properties from 2010 to 2012, financed by loans from private individuals.

At the same time I got started with the real estate, I also launched my restaurant venture. I signed up with zpizza, a high-end pizza franchise out of Newport Beach, CA. In 2006 I opened up our first location in Alexandria, VA. Within two years, we had 6 locations. We had bought two existing locations and improved the sales by 50%, but the recession hammered all locations, especially these two, and I was fortunate to sell them both for a hefty loss in 2009.

In 2007 I launched my apartment investment career by attending a Dave Lindahl boot camp. I subsequently began searching for deals in Texas, and after evaluating nearly 60 deals, I nearly bought an 81-unit in College Station (home of Texas A&M University) but decided against it because I was getting too busy with the zpizza restaurants. I also learned that investors really prefer something more local, something they could drive to if they wanted to.

In 2011, I bought a 12-unit apartment building in an up-and-coming area of NE Washington, DC. Not only was this my first apartment building but it was also the first deal I syndicated with a handful of investors. Read more about my experience here.

In 2012 I bought two zpizza restaurants with another group of investors, bringing us back up to six units.

Aside from my entrepreneurial ventures, I enjoy teaching and motivating others to move beyond their comfort zones to live the lives they were meant to live.

I developed and taught an adult education class for a couple of years that was loosely based on Rich Dad Poor Dad - we used the Cashflow 101 game as a learning tool, and people loved it.

I spear headed the roll out of the Good Sense financial counseling program at our local church and continue to help people become better with their personal finances.

I teach and coach others how to purchase their own apartment building with money raised from private individuals. Teaching others while doing my own deals allows me to constantly learn and improve myself also.

Other things you may not know about me: I hold a Masters degree in Computer Science from the College of William and Mary. I'm fluent in German (I'm actually from there) and conversational in Spanish. I play tennis competitively, love to travel, and started bow hunting several years ago. I live in Ashburn, VA with my wife and four children.