Berkeley Investment Advisors

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Pooled Investment: A Primer

This month I will explain the benefits of pooling your money to invest in real estate along with other investors as an alternative to direct ownership of real estate. We'll cover the mechanics of how these investments work and an analysis of benefits versus direct real estate investment. In the securities markets, pooled investments are extremely common: there are more mutual funds than stocks. The advantages of mutual funds versus direct ownership are:

- Professional management; and
- Efficient diversification with small amounts of capital - thus reducing risk.

In real estate, pooled investments are also fairly common, if less well known. Simply stated, a pooled investment means that a group of investors combine their capital to buy an asset or portfolio of assets. In real estate this takes two forms: Real Estate Investment Trusts (REITs) which are traded on the stock exchange and private partnerships sponsored by real estate investment firms. Both of these forms provide the same pooling benefits as mutual funds: smaller minimum investment and professional management that relieves the investor of any need to actively manage the investment.

REITs provide greater liquidity (i.e. it's easier to sell) than private partnerships. Unfortunately, they also subject real estate investors to the volatility of the stock market (i.e. the value can decline even though the underlying real estate is performing well). In addition, REITs typically will have lower after-tax returns than a well managed private partnership[1]. While I highly recommend REITs for the portion of your assets set aside for liquidity, my focus here will be on the benefits of private partnership investing.

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[1] The principal reasons for the lower returns are higher overhead (associated with managing a publicly traded company holding a portfolio of real estate spread throughout the country) and lower leverage than a private partnership.

How it Works

The company that sponsors the formation of the partnership serves as the manager of the partnership (and the real estate). This process is sometimes called syndication. Typically the sponsor has an ownership position in the partnership - meaning they receive a share of the profits of the property and thus they have an incentive to maximize returns for the syndication investors. Manager/sponsor compensation can be broken down into two components: property management fees and partnership management fees.

Property management costs are typically set as a percentage of the property revenue with a low minimum fee. Exact terms vary by property but generally fall in the range of 5-8% of collected rents for apartment properties. Note that these costs would also apply to a direct purchase of real estate by an investor. Partnership management costs involve two components: fixed administrative costs for accounting/tax reporting, and manager profit sharing. So long as the partnership has sufficient economies of scale, the administrative costs will be minor relative to the investment. Profit sharing percentages typically fall in the range of 20-30% but can be higher for certain investment types (e.g. visa qualification investments or high return strategies such as development or rehabilitation). Note that these incentive fees are similar to the fees charged for Hedge Fund management - the securities market counterpart to real estate partnerships. Investors pay such fees because the value of professional management exceeds its cost and thus investors benefit from the arrangement.

At the time the investor commits funds, the actual investment property may be owned or controlled by the sponsor, or the property could be as yet unidentified. In the later case, the investor is buying into a “blind pool” for which the investment parameters have been specified but the actual real estate has not. When the actual property is already identified the investor has something tangible to evaluate, but this requires the sponsor to commit capital to acquire the property. This increases costs relative to purchasing the property directly using investors’ funds.

Although I describe a pooled investment generically as a “partnership”, it may legally take the form of either a limited partnership (LP) or a limited liability company (LLC). In either case, the investor is shielded from any liabilities taken on by the LP or LLC. These structures are used rather than a corporation because of their tax attributes and their flexibility for allocating income and cash flow. These entities are not taxed; taxable income or loss allocations are reported to investors on tax form K-1 and taxable income or deductions flow directly through to the tax return of the investor. This is referred to as “flow through” treatment.

For investors in Japan a flow-through entity recognized in Japanese law would be used. This could be one of the U.S. entities mentioned above or it could be a Nini Kumiai or Tokumei Kumiai formed under Japanese law.

The operating agreement of the partnership provides the legal safeguards for investor capital. In general, the sponsor/manager will have significant discretion in managing partnership affairs. Rules regarding distribution of cash flows and liquidation of partnership assets should be spelled out in detail with investor approval required for deviations from the announced plans. In particular, the agreement should provide for direct distribution to investors of after-tax[2] net sales proceeds due them in the event of disposition of the property.

Since the partners cannot be required to put up more capital, the partnership must maintain significant working capital and capital replacement reserves. Typically the partnership will provide quarterly operating reports and cash distributions.

Investor returns are comprised of three components: operating cash flows, tax savings, and the capital gain when the investment is liquidated. Quarterly cash distributions of the free cash flow are the most visible (if not the most significant) return. A portion of these cash flows will be tax free because of the depreciation deductions that shelter the income on the property. In some cases these tax deductions may result in tax losses that can offset other taxable income; such tax savings constitute an additional source of after-tax return to the investor. These benefits are especially significant to investors subject to Japanese tax because of the extremely large depreciation deductions available under Japanese law for wooden buildings more than 20 years old. The icing on the cake for investors is the capital gain and return of equity when the property is sold at the end of the partnership. If the property carries significant leverage and/or the property is in a "growth market" this may be the major source of return.

A key question for investors contemplating investing in partnerships is the exit strategy: how and when will the investor get his capital back? In general, a properly structured partnership will include a built-in termination date. Circumstances sometimes make it beneficial to extend the original termination date and therefore the operating agreement should provide a mechanism for extending the term when a majority, or super-majority (say 75%) of capital shares vote to extend. In this event, there would have to be a procedure for buying back the shares of those partners who oppose the extension. A partnership may also provide for share repurchases by

[2] Escrow may be required to withhold money for taxes on sale of the property.

refinancing the property before final liquidation. The sponsor may also facilitate sales of shares for those investors who need liquidity because of some change in circumstances (e.g. settlement of an estate).

Example Deal Economics

In order to illustrate the economics, I have analyzed an apartment building priced at $3,000,000. First year net operating income (NOI) is $237,577. Note that this 7.9% capitalization rate (NOI/price) is relatively high for the current market.[3] The sponsor seeks an above-market cap rate deal so that returns are high enough to pay his fees and still satisfy investor return requirements. I.e. the sponsor must be able to add value to the deal in order for the partnership to work for all parties.

My example assumes that the property is already controlled by the sponsor and that the incentive fee is 20% of property cash flow and profit. In pooled real estate transactions, there are substantial up front costs for purchasing the property, setting up the partnership, and raising the capital. It takes some time for the property to earn back these up front costs. Therefore, in my example, the sponsor does not participate in any cash flows during the first year. By delaying participation, we ensure that the project is showing a net economic profit before the sponsor shares in cash flows.[4]

The property is acquired with a $2,100,000 mortgage with interest fixed at 6.5% for five years. The partnership raises a total of $1,200,000 from investors to purchase the property and establish a working capital reserve for operating the property. At the end of the capital raising process the partnership should have $121,000 in working capital to cover temporary shortfalls in operating cash flows. The relatively conservative leverage in this transaction (70%) allows the property to generate cash flow equal to 1.66 times annual debt service in its first year. This large cushion between operating cash flow and debt service, combined with the large working capital reserve, reduces the risk of bankruptcy to virtually nil. In the event of an adverse change in the operating environment, management would have plenty of time to either fix the operating problem or sell the property. The property could suffer 20% vacancy and grant free rent worth another 20% of gross income in its first year without exhausting its reserves.

My scenario assumes constant vacancy of 8.3%; free rent concessions start out at 7.9% of gross rents and then phase out over 18 months.[5] I assume that the (selling) capitalization rate drifts upward over time so that when the

[3] This kind of deal would require the sponsor to solve whatever problem is holding price down. In my example the problem is high vacancy resulting from major rehabilitation of the property.
[4] Note that a direct investment also faces the first year earn-back period to cover the up front costs.
[5] This is my projection for the Phoenix market.

partnership sells at the end of 10 years the purchase price implies a 9.4% capitalization rate for the buyer. The resulting cash flows provide a 12% compounded pre-tax return to investors. The pattern of investors' cash flows by year (as a percentage of initial investment) is as follows:

Year:	1	2	3	4	5	6	7	8	9	10
Cash return %	3.0	5.0	7.2	9.0	9.8	9.2	10.1	11.0	12.0	196.3
Taxable %	0	0	7	80	81	77	82	87	88	56

Benefits Versus Direct Investment

Because of economies of scale[6], larger more expensive properties will usually throw off higher cash flow returns than smaller properties. In addition, the tendency of small real estate investors to under-analyze and over-pay will often result in poor economics for properties priced within reach of smaller investors. For those investors looking for cash flow returns, but without sufficient capital (say $200,000) to buy the larger properties directly, it may not be possible to find a smaller property that provides cash flow on a par with a pooled investment. For very small investments, buying an individual property may not be possible at all.

Even if you have the capital to purchase your own property directly, it may not be the right thing to do. For one thing, pooled investments allow you to achieve greater diversification by spreading your money over several properties. Another advantage that applies regardless of your capital is that a pooled investment is a "turn key" investment for which you will have absolutely no responsibility. In contrast, if you own directly, you will be involved to some extent in management of the property. Even if you have a property manager, you will have to be involved in the acquisition of the property as well as overseeing the property manager. You are the ultimate problem solver when things go wrong.

Finally, keep in mind that the sponsor/manager provides investment expertise that you may not have. When the incentives of the manager are aligned with the interests of the investors, you can be confident that the manager will apply the maximum effort and expertise to maximizing the investors' returns.

Disadvantages/Risks

When investing along with others, you give up control over liquidity. If you own directly and suddenly need funds you can put the property up for sale and, if you price it right, you can cash out in 4-6 months. The only sure liquidity point for the partnership investment is at the pre-determined termination point. Any potential liquidity before that will come at some cost.

[6] Management costs in particular decline as a percentage of return as property size increases.

For example, if the sponsor offers to buy back shares early, it will be at a discount to the estimated value.

The other main disadvantage versus direct investing is the inability to avoid taxes at disposition by doing a section 1031 exchange transaction. When the partnership sells and distributes funds, the investors will not be able to exchange into a like-kind asset to avoid taxes.

There is also the possibility (though remote) that the partnership could go bankrupt if it is not managed properly or if it does not have adequate capital reserves to withstand operational problems. (Note that this risk also applies to investing in stocks).

Conclusion

Pooled real estate investments allow investors to access real estate returns via a "turn key" investment where expert management has incentives to maximize returns for the investor. In many cases, this will be preferable to direct real estate investment – especially for investors with limited capital or a lack of time to put into the direct investing process. If this might be right for you, contact Berkeley Investment Advisors to find a pooled investment that suits your return goals, your risk tolerance, and your investing time horizon.

Featured Investment Opportunity

This is a pooled investment in an industrial property located in south of downtown Seattle in an area on the verge of redevelopment and transformation to mixed use – similar to the SOMA area of San Francisco. The property is leased on a triple net lease. The property is purchased from the sponsor at a capitalization rate of 9% and the sponsor's incentive fee is 30% of income. Investor money is used to pay down existing mortgage debt to zero. Thus the cash flow yield to investors is expected to be 6.3% (9% * 70%) in the first year. There is significant potential for appreciation because of the likelihood of the area being rezoned to mixed use (office, retail, industrial) in the next 5-10 years. Call for further details.

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280 Tokyo phone: (080) 3122-9601		RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332