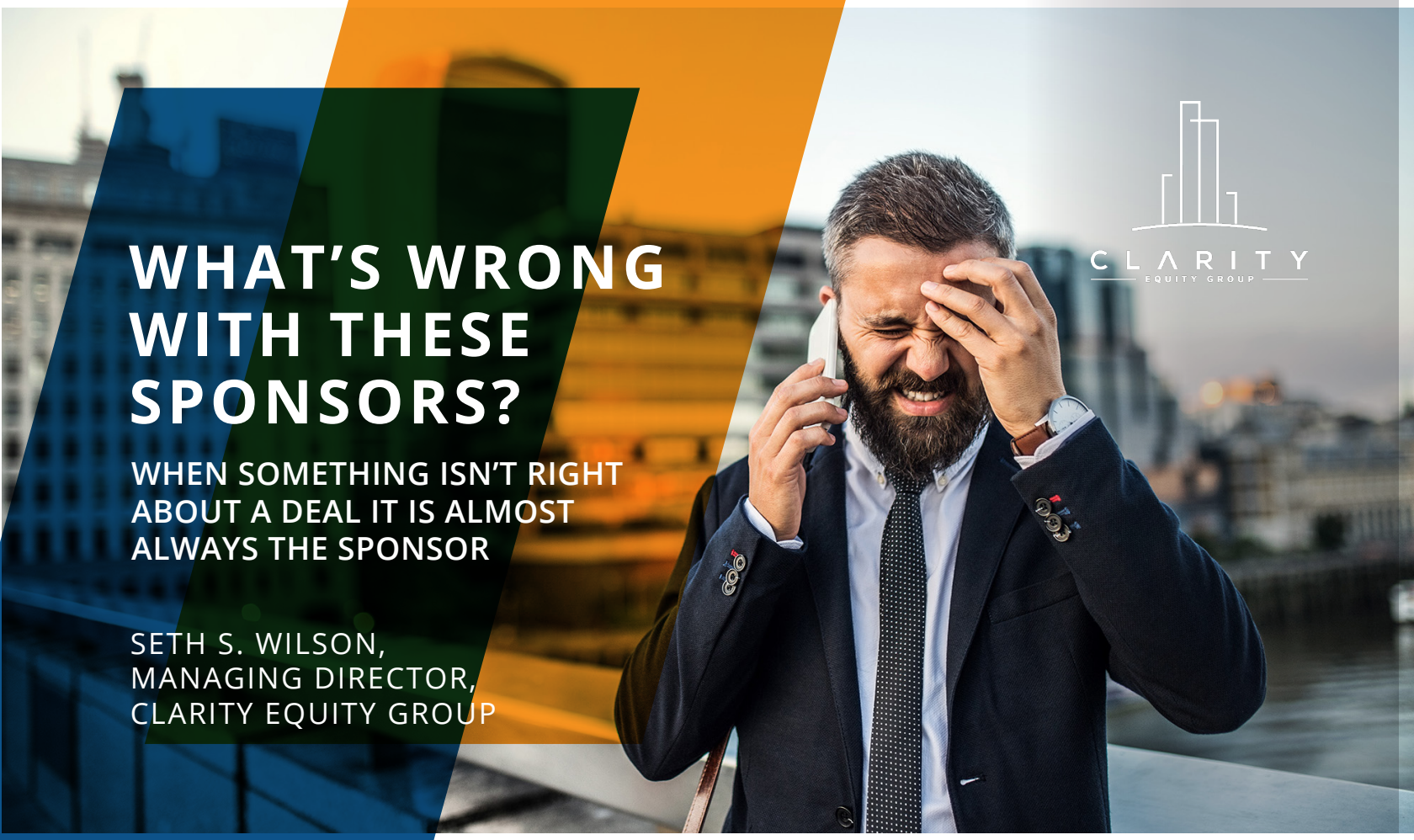

WHAT'S WRONG WITH THESE SPONSORS?

WHEN SOMETHING ISN'T RIGHT ABOUT A DEAL IT IS ALMOST ALWAYS THE SPONSOR

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Sponsors go by many names: General Partner (GP), owner/operator, principal, and maybe some others I haven't heard of. The sponsor is the person who is running the show in a real estate investment. They source the deal, structure the deal, raise both debt and equity for the deal, run or oversee the day-to-day operations of the deal, oversee the contractors and vendors that will work on the property to decide when and how much to release in dividends, when to sell or refinance the property and for how much. There is a lot of responsibility on these individuals.

Sponsors raise equity and/or debt from Limited Partners (LP). As an LP, it is your job to fully understand what the GP is doing, how they are going to do it, when they will do it, and most importantly when and how much of your investment will come back to you. A minor challenge is that many LPs blindly invest with a sponsor without understanding the business or how the sponsor will accomplish their stated goals. The real issue is that often the GP also doesn't understand how they will accomplish their stated objectives or how they will effectively exit the property. Even if they do understand, they need to have a track record of completing successful projects.

A saying in the business is that a good sponsor will make a marginal deal good, and a marginal sponsor will make a good deal bad.

How do you as an LP and (let's say) me as a capital allocator avoid the bad apples, the bad deals, and the marginal or outright bad sponsors and only work with the best of the best? Here is a sampling of the high points that I look for before allocating any capital to a sponsor.

What's Wrong with These Sponsors?

First things first, in a commercial real estate transaction, the GP needs to be suitably qualified in the following areas:

Capital: The sponsor must have sufficient capital to co-invest in the transaction. At Clarity we like to see 10 to 20%+ of the equity stack come from the sponsor. This is often called "skin in the game." While this is a rule of thumb, they may come with less than that percentage for a truly compelling opportunity.

Construction: The sponsor must be qualified to manage the construction needed to rehabilitate the property if that is part of the property plan. Are they going to be the General Contractor (GC) on the property or will they use a third-party company? Neither is wrong, but we must have a good understanding of how the sponsor will work with vendors and their relationship. There is nothing worse than a sponsor who is going to do everything on their own. They will spread themselves too thin and will quickly burn out.

Management: Be qualified to manage or oversee the day-to-day operations of the property. Management is one of the three legs of the three-legged stool that I wrote about in my book Real Estate Flight Plan. This book can be purchased on Amazon.com, or you can get it as an eBook for free at ClarityEquityGroup.com. Management is the lynchpin that keeps the project running and heading in the right direction. This is the blocking and tackling that is tough; it is tough to keep staff happy and all on the same sheet of music so that they will take care of the tenants whether they live on property as in a multifamily property or are professionals working in an office. While the sponsor doesn't necessarily manage the property themselves, they must have a strong working relationship with the company that will.

Infrastructure: Does the sponsor have the appropriate organization to take on the project? How will the back-office work get done and by whom? While it is not a glamorous job or exciting part of the business, it is where the score card is created, updated, and kept (by score card I mean the financials). I am surprised by the number of sponsors who can't read their own financial statements, let alone create one.

Leasing: Be qualified to oversee the leasing effort. Leasing falls under management and it is worthwhile to make a separate line item for this to show the importance. No company will survive without sales. No property will survive without a healthy leasing strategy and happy tenants paying on time and in full every month. It is critical that a solid leasing strategy be in place for any property but most certainly for a value add or opportunistic property.

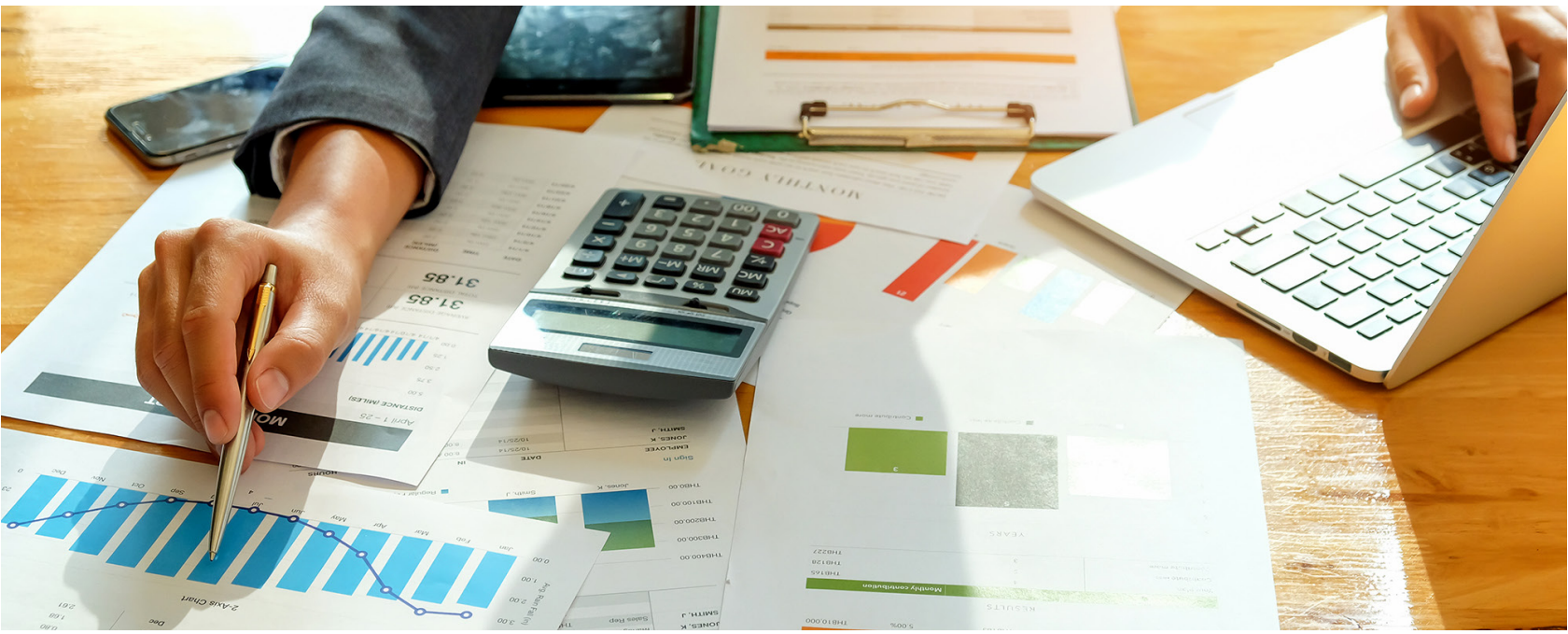
Staying power: The sponsor must have a sufficient net worth to support the property if unexpected costs overrun the budget or if delays occur. This is a tough thought to quantify, but what it comes down to is this: If there is a budget shortfall or the property requires more funds than what are on hand, will the sponsor be willing to go into their own pocket to make up for the shortfall by extending a no-interest loan? Not only will the sponsor be willing to put additional capital in but will they have the wherewithal to make it happen? If not, then what happens when the property needs additional capital to operate?

There are some other challenges for a sponsor as well beyond just the aforementioned:

TOO PASSIONATE

Passion is great in lovemaking, good in hobbies, and a destructive force in commercial real estate. Commercial real estate (CRE) is slow moving and ultimately boring. CRE is not supposed to be exciting day-to-day—everything should be planned well in advance; operations should be methodical so the property moves straight down the rails as set forth for it in the property plan. If the person raising capital from you is passionate or excited, they are letting their emotions get the best of them and may not be thinking clearly.

CRE is a tangible asset. Yes, it can be exciting to drive by the property with your golf buddies and brag about how you own a piece of it, but ultimately it is just sticks and bricks. What is on the income statement and balance sheet is really important. Kids don't pay for college with their parents' ego; they need greenbacks. So, make sure you and your general partner put their passion aside and look at every deal dispassionately. As final thought: I see "the deal of a lifetime" about once a year—then, even so, I dispassionately invest in it.



LACKS ALIGNMENT OF INTEREST

Alignment of interest is critical in anyone you work with. Alignment of interest is not manifested in high fees and loads or recurring fees. If the GP is attempting or proposing to get a fee on every line item (acquisition fee, disposition fee, asset management fee, management fee, disposition fee, Easter bunny fee, refinance fee), they do not have a good alignment of interest with their LPs. They are more interested in managing money than they are in assuring that the property and partnership will be a success.

The best way to have a solid alignment of interest is for the GP to have small fees. Yes, they need to keep the lights on at the office, so fees are normally necessary. If they truly have conviction in their project, they will structure it in a way that the investors (LPs) get the bigger slice of the pie and then really focus on growing that pie for everyone.

SAYS/DOES STUPID THINGS

I am amazed at the number of people who interview for a job with me, attempt to raise money from me, try to sell me a car, or otherwise try to get money or time out of me and just cannot help themselves from saying the stupidest things. I believe a lot of these misspeaks have to do with the person not being an experienced expert in their field.

Regardless, if they are an expert and say or do dumb things, I don't want to work with them and doubly if they aren't experienced and say stupid stuff, I really don't want to work with them.

An example is this: I was being pitched a deal to allocate equity capital. The gentleman started the conversation by stating: "I know that this property is in a horrible location..." I stopped him there and told him that I wasn't the investor for this project. Also, every deal he sends to me in the future is now suspect.

Doing stupid stuff is worse than saying dumb things. Doing can have some dire consequences to a partnership and to a property. Just avoid these ducks and look for eagles because, as investors, we only want to work with people who soar like an eagle, not waddle around quacking like a duck.

IS A DUCK NOT AN EAGLE

Eagles are experts in their field, they are sharp as a tack, they are enthusiastic yet dispassionate about every property and business in general. When you find an eagle, you will know it. They have experience, are confident in their abilities, they have been there and done that. They can educate you and give you insights that you may not have thought of. They are plugged into the market, have their ear to the ground, and can quickly and clearly tell you which way the wind is blowing. These are the people that you and I want to work with.

When I was in Air Force pilot training, we were graded on every flight: Excellent, Good, Unsatisfactory (unsat). An instructor told me how he was going to grade me: I would get an unsat if I did not meet the training course guidelines. I would get a good if I met the course standards. Finally, he would give me an excellent only if I could fly the maneuvers better than he. Always be looking for the smartest person in the room that will do better than you, and partner with that eagle.

DOESN'T ALWAYS CREATE VALUE

There is no reason to contact a businessperson that you have a working professional relationship with if you aren't creating value with your communication. Everyone who works for me knows that when they are out-facing from Clarity that they must provide value to the individual/group/company that they are interacting with; otherwise, how are they supposed to prove they are an eagle? The "just checking-in" emails and phone calls are not only useless, they are a waste of time. We don't waste our clients' or investors' time. Make sure your sponsors are not wasting your time—or money!

If the sponsor wastes your time on the phone or in an email or in a meeting, they will probably also squander opportunities that could be made within the partnership and at the property. There is no shortage of chances to find "good news money" at a property or to cut costs that ultimately add value to the partnership and the investors.

Good news money is money that is not expected or underwritten when the real estate partnership was formed. An example is when I sponsored a partnership, we went looking for good news money and found it in a $30,000 opportunity to re-lease our washers and dryers with another company that was willing to give us new, more reliable machines and a "redecorating bonus" of $30,000. While it wasn't life-changing money, it is a perfect example of always looking for ways to create value.

PLAYS TO THEIR WEAKNESSES

We were all born with certain innate characteristics that we carry with us throughout our lives. Some people are athletes; some are born leaders or good with numbers or words. Whatever your strengths are, you are probably acutely aware of them, and you are more than likely aware of where your weaknesses are.

In the knowledge economy that we live in within the information age, there is no reason not to play exclusively to your strengths and outsource your weaknesses. All too often, though, sponsors will try to do it all and be everything to everyone. They can't.

A smart sponsor knows that they will only capitalize on the strong abilities. For example, a sponsor may be savvy with underwriting and seeing patterns in the market, but they are acutely aware that they are not good at raising capital or managing a property day-to-day. In this case they should stick to what they know and partner or outsource the rest.

Unfortunately, this isn't always the case. The sponsor will attempt to play Superman and do it all himself. This is a recipe for disaster as they will pick a good property and not be able to raise the required funds to close on the deal; or if they do, they will mismanage the property so poorly that the partnership loses a significant amount of money in the process.

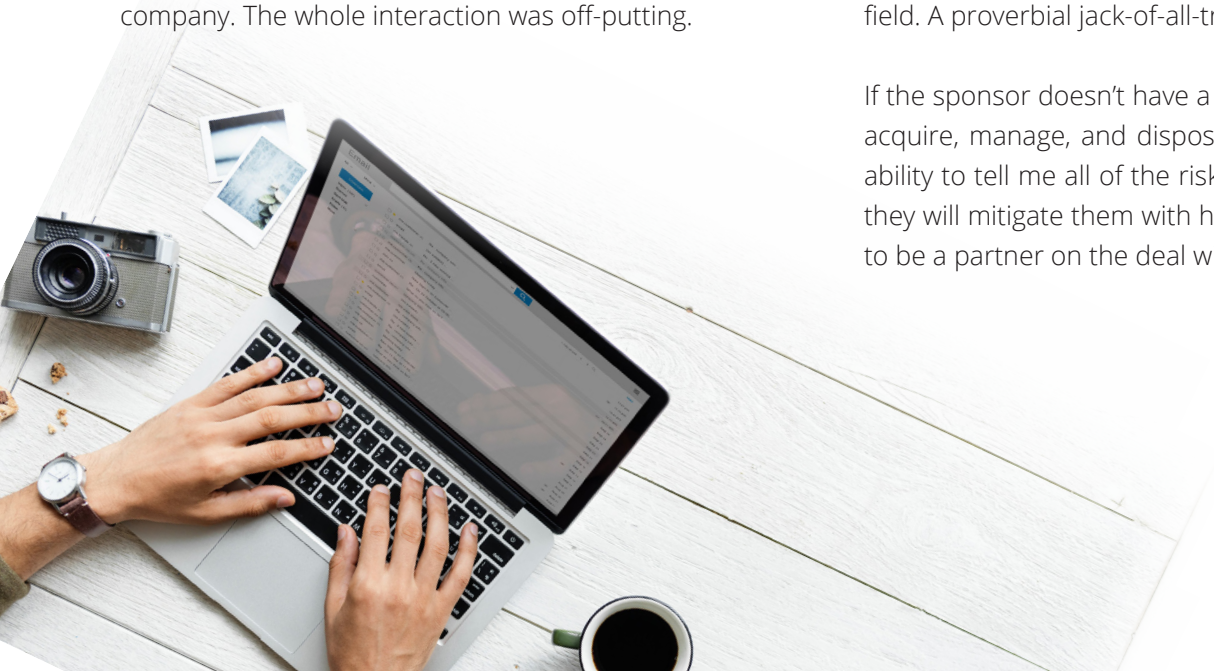
As a reminder, a bad sponsor can turn a good deal into a marginal or even bad deal, especially if they don't understand and play to their strengths.

LACKS SPECIFICITY

Recently I was told I had to meet with an up-and-comer in commercial real estate. I met with him in person, and the first thing he did was add me to his email blasts, which is fine, but he had no fewer than five different opportunities he was pitching that had no cohesion in geographic focus or asset type: One deal was stabilized, one was value add, one was for new construction on a retirement facility, and the topper was a pitch for a green energy start-up company. The whole interaction was off-putting.

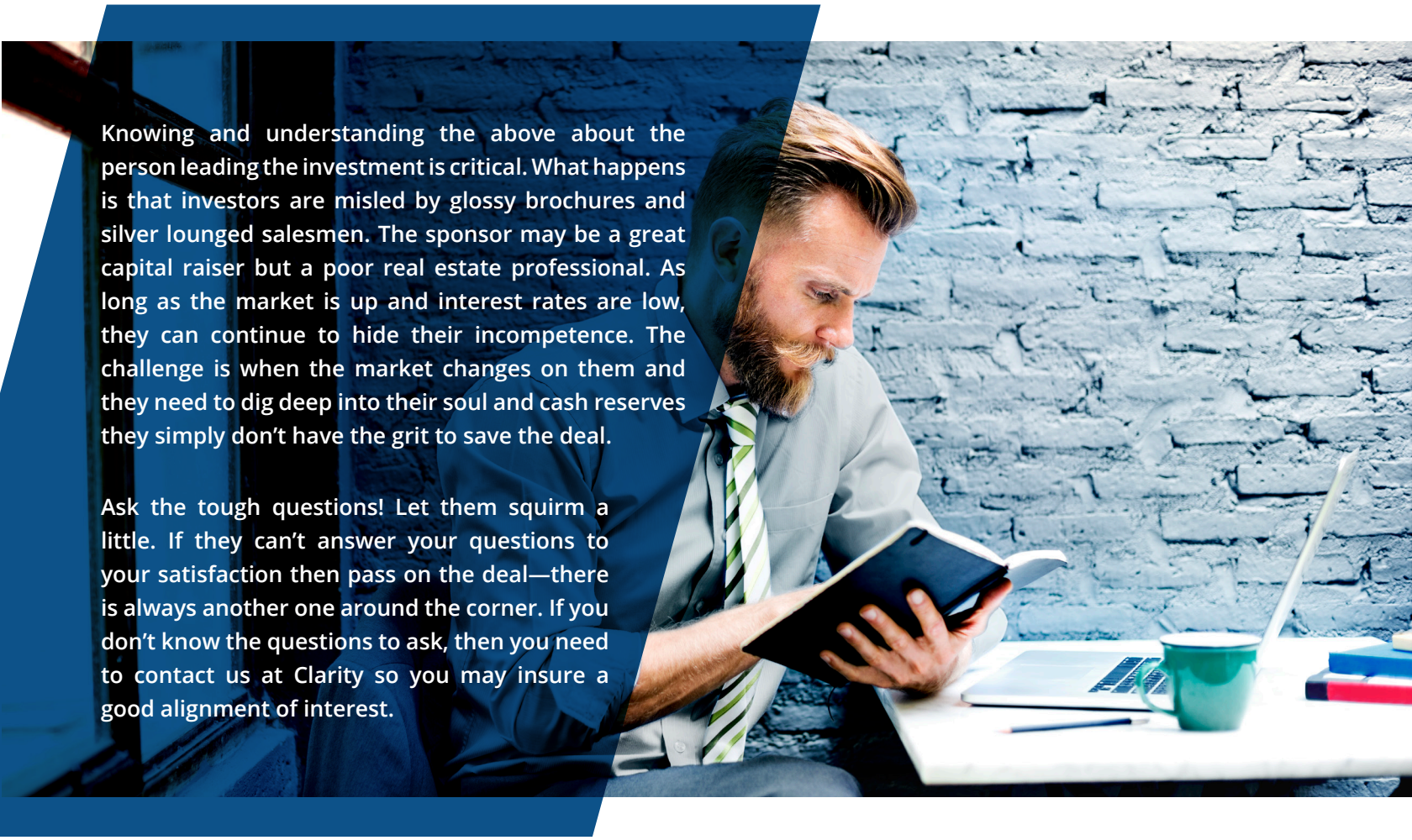
He had no idea where my interests lie; he had no idea what I can and can't do for him because he never asked. That aside, what is this guy's business? What does he do? What is he trying to do? Is he like a dog in heat and will run up to property that he thinks he can make a buck on and then throw it at his email list to see what sticks? If so, that violates the "always add value" rule. This lack of focus makes it hard for me to believe that he is an expert in his field. A proverbial jack-of-all-trades but a master of none.

If the sponsor doesn't have a clear picture of how they will acquire, manage, and dispose of an asset, as well as the ability to tell me all of the risk factors in the deal and how they will mitigate them with high specificity, I won't be able to be a partner on the deal with them.



JUST DOESN'T ADD UP—LITERALLY

Often figures don't add up. The numbers I am given just do not balance. So let's say you are raising $9MM, but you only have uses for $8.7MM, so where is the other $300,000 going? Ugh. "Yeah, I am going to have to put my pencil down until I get the information that I need." Trust me, they will never contact me again. These types of glaring holes are easy to spot when you know what to look for. Really something only experience, or a calculator, can teach. The GP simply can't communicate the numbers in a clear, concise manner, which also violates the "specificity" rule.



Knowing and understanding the above about the person leading the investment is critical. What happens is that investors are misled by glossy brochures and silver lounged salesmen. The sponsor may be a great capital raiser but a poor real estate professional. As long as the market is up and interest rates are low, they can continue to hide their incompetence. The challenge is when the market changes on them and they need to dig deep into their soul and cash reserves they simply don't have the grit to save the deal.

Ask the tough questions! Let them squirm a little. If they can't answer your questions to your satisfaction then pass on the deal—there is always another one around the corner. If you don't know the questions to ask, then you need to contact us at Clarity so you may insure a good alignment of interest.

This white paper was written to add value to your commercial real estate investing. I hope I did that for you, your family, and/or your firm. This white paper is a derivative of Clarity's 10 Commandments of Commercial Real Estate.

Connect with Clarity Equity Group on LinkedIn as we are constantly putting up new and valuable content daily.

Also feel free to call 816-945-8181 to see where Clarity fits in your commercial real estate capital allocation for superior deal flow, structure, and expertise.