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Vetting an Apartment Deal Sponsor: Ten Tips from an Insider

I attended a multi-family meetup group here in Austin this past week and the topic raised by one of the attendees who was new to apartment investing was how to vet a deal sponsor as part of the investment valuation process. As part of a deal sponsor team that has done six large multifamily apartment acquisitions over the past year I understood her challenge, especially as a new investor trying to come up to speed. So, I essentially told the folks attending that I would do a blog on this topic to help provide some guidance.

In every deal I evaluate, I like to look at three main things:

- 1) The Market
- 2) The Deal
- 3) The Team

This blog article will focus on number 3 (The Team, aka Sponsor) however I would say they are all important. Some would say, and I probably agree, that the market where the apartment is located is by far the most important element here. You can have a great deal and a great team, but if you are in a crappy market or location (think non-growth or declining; crime ridden; etc.) you are not going to be very successful, period!

Give me a great market and a great team and an ok deal, and you can still make some good money because the market and the great team will cover up and manage through some of the deal challenges. Give me a great market and a great deal, but a bad

and inexperienced team and you can lose your shirt, end of story.

So, yes, you want all three in your favor but let's focus on the sponsor (sometimes referred to as the general partner, deal sponsor or syndicator). What should you be looking for in a sponsor? I will tell you, as a person who has his own company dedicated to raising private equity from accredited investors and works closely with select sponsors to help fund and acquire apartments, that I have firsthand experience as to what is most commonly asked, what is not, and what probably should be. I'm part of the general partnership team on each deal per SEC requirements to market the deals so I'm very close to how these sponsors operate and what to look for. I put together a list of 10 things to consider to make it more convenient to think about. They are in no particular order of importance. This is not an all-inclusive list but as you gain experience, you may add to the list or modify it to suit you. But again, I'm just focusing on the sponsor, not the market or deal which reminds me those would be good topics for another blog article or two. So here are my top 10 suggestions:

1) Sponsor Company and Partner Backgrounds

- a. Does the company have a website? Is it well organized and thoughtful?
- b. Do they lay out their strategy and does it seem conservative and disciplined? Process oriented? You want singular and focused strategies.
- c. Are all the key partners listed with their bios?
- d. How long have they been doing this business? *Can you identify with at least one key partner with 10 yrs. experience (thru a full market cycle) or have all the partners just started? I'm ok if*

the business has only a few deals if newly formed, what I really am looking for is the tenure and experience of the partners in this industry.

- e. Google their names and make sure nothing bad comes up. Go to LinkedIn and Facebook; review any articles or books they have written. **You are looking for honest, high integrity, high character folks here.** Spend some time and use your gut instinct if something doesn't seem right or is not aligned with what they are saying in their bios, company mission's statement, philosophies or what you are uncovering in their histories. The big ones would be bankruptcies, felonies, or SEC or state violations as red flags. This is a well-regulated industry and compliance is a top priority.



- f. Are they active in online real estate investing forums? I am a member of BiggerPockets (an online real estate investing social network). If a sponsor is active there, it is easy for prospective investors to simply ask in the forums has anyone ever participated in “so and so's” deals before and would they mind going offline to discuss. I've seen online as well but that may not be the best way to take the discussion for a variety of reasons.
- g. Review their marketing materials (deal summary deck, videos, listen to the conference call if provided). Is everything looking professional, organized and is the business plan simple and clear? How do they handle investor questions on the conference call? Do they present themselves professionally and address all questions thoughtfully.
- h. What's their reputation? What have the partners got to lose? I like focus (fulltime) syndicators but I'm ok if they have related businesses. *The sponsor I work with has an active apartment coaching business teaching students about how to get into this field and succeed; and a nationwide podcast interviewing experts on their best real estate*

advice. So, if he becomes a “bad apple” at some point, wow, he loses 3 businesses including his main business of being a sponsor for large MF deals and losing his main ability to raise capital and do deals. He and I agree that one's reputation is everything in this business! Reputation is so important that you are soon out of business if you don't protect and maintain it.

2) Track Record

- a. Does the company have a track record that you can review? *Sometimes the projects and track record are posted on their website so it would be good to see that. If not, request it.*
- b. You want to see consistency in types of projects they are investing in? (*Example: do they only do large value-add, class B apartment properties or are they all over the place; A/B/C/D including other niches like storage, etc. or strategies like turnarounds, momentum plays, etc.*) The simpler, more consistent strategy is best. You get very good at focus.
- c. Performance - ideally, you'd like to see evidence of returns (cash on cash %, growth in NOI, consistent distributions especially if there is a preferred return) at or above the original business plan forecasts and within industry expectations. For instance, in large apartment value investing, 10% cash-on-cash returns and 20% IRR over a five-year hold is reasonable to achieve as of this writing. If I see a deal promising 15% cash-on-cash return and 25% or higher IRR I get a little nervous. If a sponsor does 10 deals, it's invariable that, the sponsor may have a deal that is just meeting expectations, as no one is perfect in this industry. However, if the sponsor states a preferred return to investors, that return should be hitting 8%. *The sponsor does not get paid under a preferred return plan until the limited partner (investor) gets paid up to the full 8% of stated target.*

3) References

- a. I get asked for references from time to time by investors considering their first investment with us. I'm more than happy to provide references to investors. I usually will seek out an investor or two who have been in our deals longer and in a couple of investments. I try to provide different references so I don't overburden any one of our investors but I think it helps and investors who do this extra step seem to like it. You may want to ask questions like:
- i. *How has it performed (you want at least at or above expectations)?*
 - ii. *How are the communications quality and frequency with the investors?*
 - iii. *Any issues or concerns you have experienced and how have they been handled? (you want promptly...with a corrective action plan / process improvement attitude from the sponsor).*

4) Investor Relations

- a. Availability - Does the Sponsor have time for you?
- b. Do they make themselves available to answer your questions and educate you?
 - i. *You should be able to talk to the sponsor directly.*
 - ii. *You should be able to ask the sponsor just about any question and they should be able to answer you promptly with a quality response.*
 - iii. *Are you comfortable with their responses? Do they help educate you on technical areas? Sponsors want to have long-term relationships with their investor so if they are not answering, you could get a sense that they are not thinking long-term about this business and where does the limited partner (investor) sit in this relationship. You want to feel as an equal partner, you should be well informed and very comfortable with your investment and how you are treated and communicated with is very important.*
- c. Can you tour the property? *If an investor wants to see the property, I'll line that up with the property manager and meet them as well if possible.*

- d. Communications Schedule - *A good sponsor should give you an example of an investor communications schedule and some correspondence on past deals for you to review. The schedule should contain frequency of communications, timing of distributions and K-1 statements for tax purposes, how you can contact the sponsor and other handy tips.*



5) Conservative Underwriting / Assumptions and Forecasts

- a. This might be one of the most important points, and I cannot overemphasize that a good sponsor should be principled in being conservative in the numbers and assumptions that make up the business plan and investment performance projections.
- b. Words like “**capital preservation**” and “**conservative underwriting**” should come out loud and clear on the company website, any projects you are reviewing, etc. It's not rocket science, but a lot of common sense. The business model in value-add apartment investing with experienced sponsors is quite attractive financially so there is no compelling reason to embellish the numbers or stretch. You can conservatively post numbers that gain investor attention and interest and pleasantly surprise them during the duration of the investment with upside performance. Why take risks in forecasting higher numbers and then struggle to meet them consistently.
- c. You will want to review the sponsor's assumptions carefully for every deal you analyze. Better yet, a good sponsor in dealing with more sophisticated investors will put together a **sensitivity analysis** report that shows you how your investment returns are impacted when four key areas of the investment model change (*occupancy, rent, interest rates and cap rates*). This can cause your investment returns to

change either positively or negatively. I focus more on the worst-case scenarios and see if I can still live with it. Here's an example of how a sponsor might take different assumptions. Let me set this up. *We bought a property where 25% of the units were already renovated and the previous owner was getting \$100 more in rent across all sizes of apartment units (studio, 1x1, 2x2, 3x3). The market comps around us for renovated units were about \$115-\$125 more per unit. The company underwrote the deal at \$71. That's a nice spread, from \$71 to \$125. The market can go soft and you can still make good money for the investor at \$71. A more aggressive assumption might be to assume \$100. Even more aggressive, assume \$115 to \$125 and show your investor a greater return. Publishing this more aggressive assumption is not a good idea. Remember, you always want to under promise and over deliver, so be conservative. Same with occupancy. Submarket was at 97%, we were at 95% upon purchase, but we show even if the market had a melt down and we got 81% occupancy, we still yield 6% to the investor, not great, not good but solid in a market meltdown.*

6) Sponsor / Limited Partner (Investor) Payout Structure

- a. Review the payout structure and understand how the sponsor, you, and the investor get paid.
- b. Common industry splits can be 20 – 40 % for Sponsor and 60 – 80% for the Limited Partner. I'm comfortable up to about 30% and I'm generally comfortable with a waterfall but as a marketer of deals it complicates things when talking with investors. A waterfall is where after a certain hurdle rate is reached (typically IRR measured) the split can change. *Example: up to 13% its 70/30. After 13% up to 18%, split changes to 65/35 and so forth. The idea is that the sponsor will get a higher return (incentive) by showing a stronger performance. Again, if an investor is being shown a 20% IRR then the waterfall should already be taken into consideration in the forecast.*

- c. **Preferred Return** – I personally like to see a preferred return in the deal. This favors the investor. There is no guarantee when you invest in these deals, however, the next best thing to a guarantee for the limited partner is a preferred return. Typical preferred return is 8%. What this means usually is that any distribution, refinance or sale that creates cash to the investor, the first 8% (to equate to an 8% cash-on-cash yield) will be paid to the limited partners and the sponsor gets nothing until we exceed that threshold. Above 8%, then the payout reverts to the split agreed to, which is often 70% to the investor and 30% to the sponsor. Be careful here. When comparing deals, I often see “club” investors that are over focused on working with sponsors that only take 20%, but club deals I see don't have a preferred return. So, all things equal, I'd take the preferred return any day and be fine with the 70/30 split after that. Do the math, it takes a significant return say mid-teens and higher before you'd see an even tradeoff. I feel with an 8% preferred, I'm essentially getting as close to a guarantee as possible. An 8% return paid these days is darn good and knowing the sponsor gets no return until me, the investor gets this, would be important to me as an investor.



7) Sponsor Fees / Investor Alignment

- a. The first two are very common fees, the others are optional:
 - i. Acquisition fee (1-3% of the purchase price of the apartment paid to the sponsor at closing) – This is for all the work the sponsor goes through to find just this one great property but having to look at, analyze over 50 to 100 to get to this one. It is designed to cover all the work leading up to the close including taking care of the staff, administration,

analyst, marketing, etc.

It's a one-time fee. I can live with 2%.



- ii. Asset Management fee (1-3% of the monthly revenues generated by the apartment) – This is usually paid out quarterly to the sponsor. This is primarily to cover the costs and time associated with ensuring the apartment management company executes the business plan. Again, I see 2% as common.
 - iii. Loan guarantee – Sometimes you will see this because the lender requires one or two of the key sponsors to put up their net worth as collateral to the size of the loan. So specific folks on the sponsor team want to get paid to take on that burden / risk even if non-recourse loans are common (*as carve-out rules usually apply*).
 - iv. Refinance hurdle award (say 2%) – This should be set high, like 60 to 75% which essentially rewards the sponsor if they create so much value that when they decide to refinance and pull money out to the investors that if they get say 75% of the investor capital back that they get a 2% bonus as part of exceeding expectations. I tell investors if we hit this number, the investment is an absolute home run and we deserve it. It should be set very high, a real stretch.
 - v. Disposition fee – Typically this fee is 1% of the sale price paid to the sponsor for all the work in selling a property. Optional.
- b. **Fees** should not impact projections shown but double check. It's common that the cash on cash return and IRR you are shown in the 5-year projections on the investment are after fees have been taken out. In other words, if the investment projects say a 10% cash-on-cash yield and a 20% IRR over a 5-year hold, that is what the sponsor is targeting for you to receive assuming the sponsor executes to the plan. Hence, you should not expect your returns to go down just because there are sponsor fees. A good forecast should bake all that in. If there are

performance hurdles or waterfalls, those assumptions should all be baked in with no surprises.

- c. **Sponsor Investment Commits** – I like to see sponsors invest in their own deal. I'm not hung up on how much that is really but I'd like to see it be at least the minimum for an investor or something that makes sense. If most of the partners on the sponsor team are putting up money I feel better. Now, I know a lot of sponsors who don't and that would not preclude me from investing with them. Why? Because as a sponsor, there is a ton of work involved; skill and knowledge and experiences that are brought to bear to make this a great investment, often termed "sweat equity". Having the sponsors put more of their own money in the deal from a symbolic standpoint is a good thing but you shouldn't expect them to be betting the ranch with their personal funds. Additionally, I worked with a sponsor who put together 6 deals in the past 12 months. I can tell you his financial planner would not be advising him to invest his own money in every deal, at least not much, because he, like you, should be thinking about his overall financial picture. This is akin to folks who used to put all their 401K money in their company stock. Probably not too smart if you have your livelihood (salary / bonus) already in the deal which the sponsors essentially have, as most are pursuing this on a full-time basis. One easy way for sponsors to put money in the deal is just take a percentage of their acquisition fee and put it in the deal at close. Again, it shows alignment with the other investor partners and that, in general, is a good thing but don't get hung up on it. Once you have been a sponsor you will realize they earn it.

8) The Property Manager

- a. It's common that a sponsor will hire a property management company to oversee the day-to-day operations. Again, the sponsor will be very involved as the asset manager but looking at more of ensuring the property manager executes

the business plan to add value and create a great apartment community. Good reputation and experience is essential as the right property manager will make or break a good deal in a good market.

- b. Review the property management company that the sponsor uses or will be using on the project you are evaluating.
- c. Check out their website and do many of the things we discussed above in #1. Review backgrounds of the key leadership team.
- d. Do they have a track record of solid performance?
- e. How many properties do they manage, what types (classes) and sizes? (If the sponsor is focusing on class B value-add apartments and the property manager is mostly sustaining class A buildings, this is not a good fit). I also like one with size as they can better negotiate with vendors to cover multiple communities.
- f. A good apartment manager will also focus on “making a community.” Studies show few residents at apartments even know their neighbor. To improve relations and a sense of pride in the apartment community, what is the manager’s plan to improve community purpose, comradery, caring and fun for the residents? These are qualitative factors for sure but have direct quantitative impacts such as increased resident retention, lower turnover, referrals, etc.
- g. Is this a new market / submarket for the manager, or do they have other properties in the area?
- h. They should be focused on education, training and processes with state-of-the-art software.

9) Asset Management

- a. This is done by the sponsor.
- b. I would ask the sponsor what are his key actions, plans and routines to stay on top of the apartment manager and the community.
- c. Is he in the same town? That is not critical if he is flying in often enough to ensure the apartment management is on top of its game.
- d. I like to see the sponsor team providing monthly emails to the investors on project status. It could be as simple as a 4-5 bullets on what has been

accomplished that past month, how they are handling any issues that came up and protecting your investment. Are they responsive when investors have a question and do they work well with the apartment manager in quickly addressing the issues?

- e. Quarterly, you should be able to get the full financial readout from the property manager on the actual vs budget figures. See Investor Relation and Communications schedule above as that is normally where you will see this addressed.

10) Holistic Win / Win

- a. If done right, everyone should win. The sponsor and investor should win, the property manager should win, the resident should win, the community should win and all the support folks including the lender, broker, etc. should win.
- b. When you are talking to the sponsor and their representatives (could be the core team) and extended team players, get a sense of how they talk about the sponsor and how the sponsor talks about his team and supporting cast. All the integrity, character and other essential ingredients we mentioned earlier in vetting the partners should resonate loud and clear. You want a sponsor that cares and wants everyone to win. Yes, it may be an intangible and hard to see, but with enough conversations including going to past properties and just seeing how they are functioning, your gut instinct will tell you if this is the right sponsor to oversee your investment or not.

I hope you found these lessons helpful and enlightening as you vet out sponsors for your deals. The great news is this, once you find a great sponsor, you can usually reduce a lot of this work on future deals and continue to ride with them on future deals... focusing more on the market and projects they are presenting to you. Once sponsors find a philosophy, model and formula that works, it’s usually consistently repeated over and over.