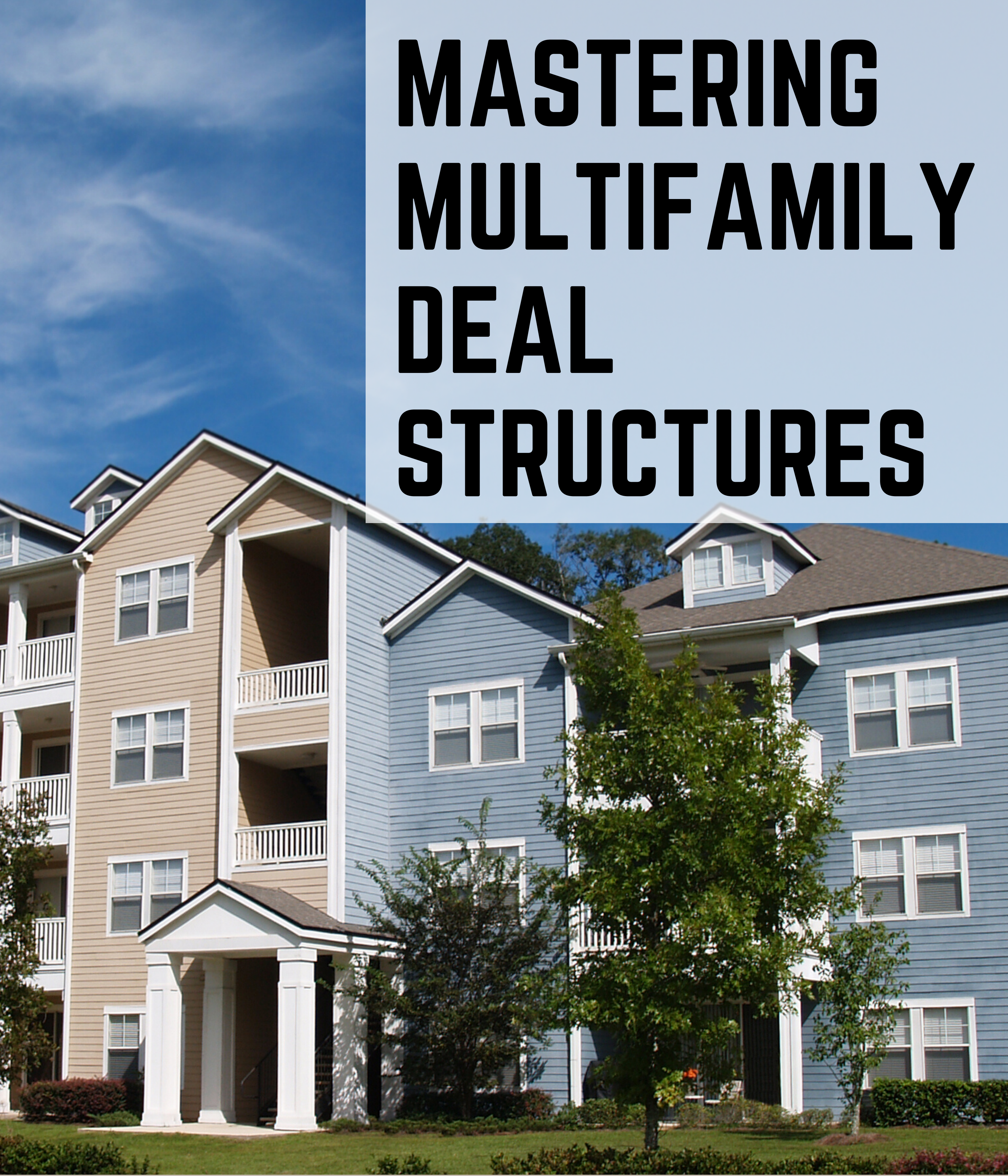
# MASTERING MULTIFAMILY DEAL STRUCTURES



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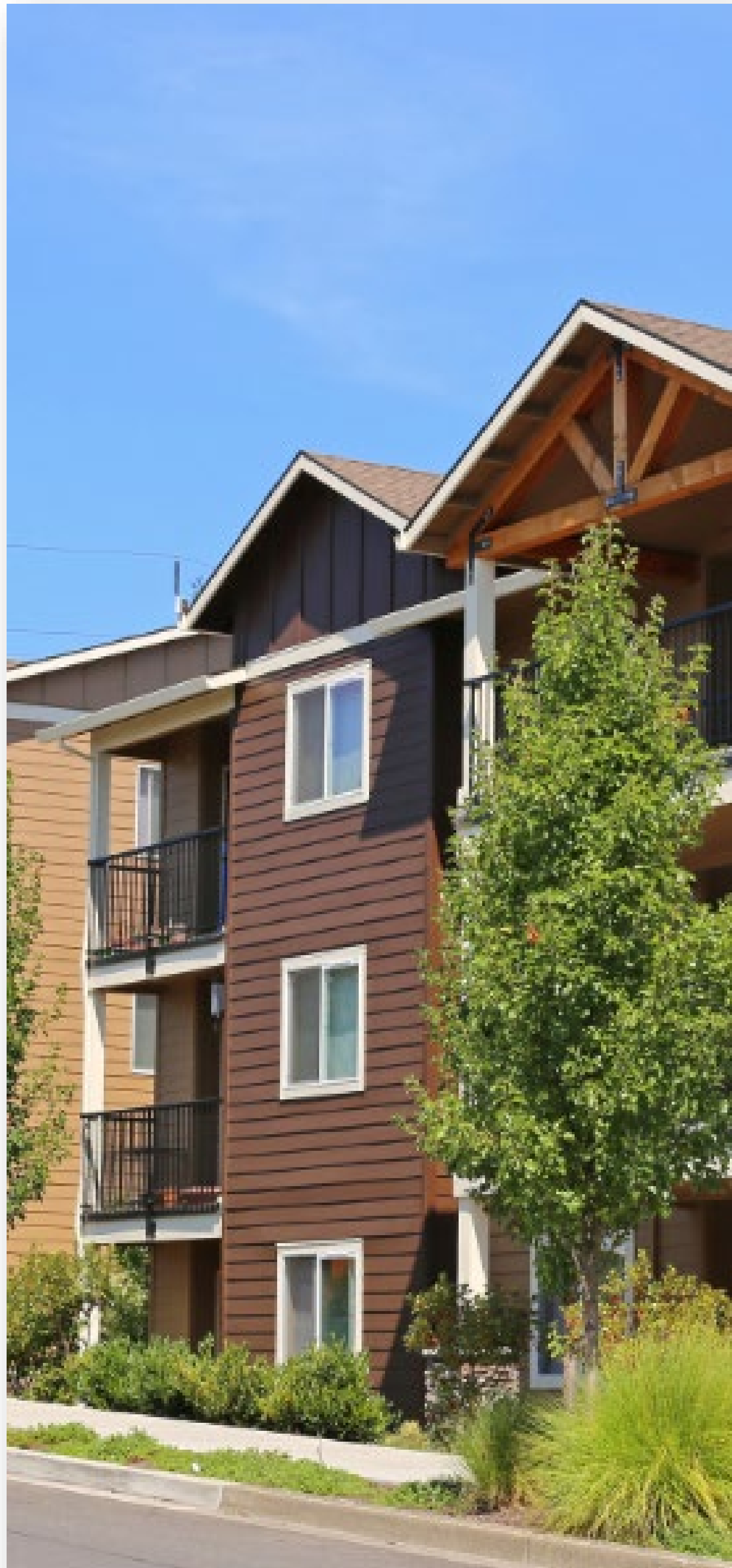
MULTIFAMILY MASTERY

# Contents





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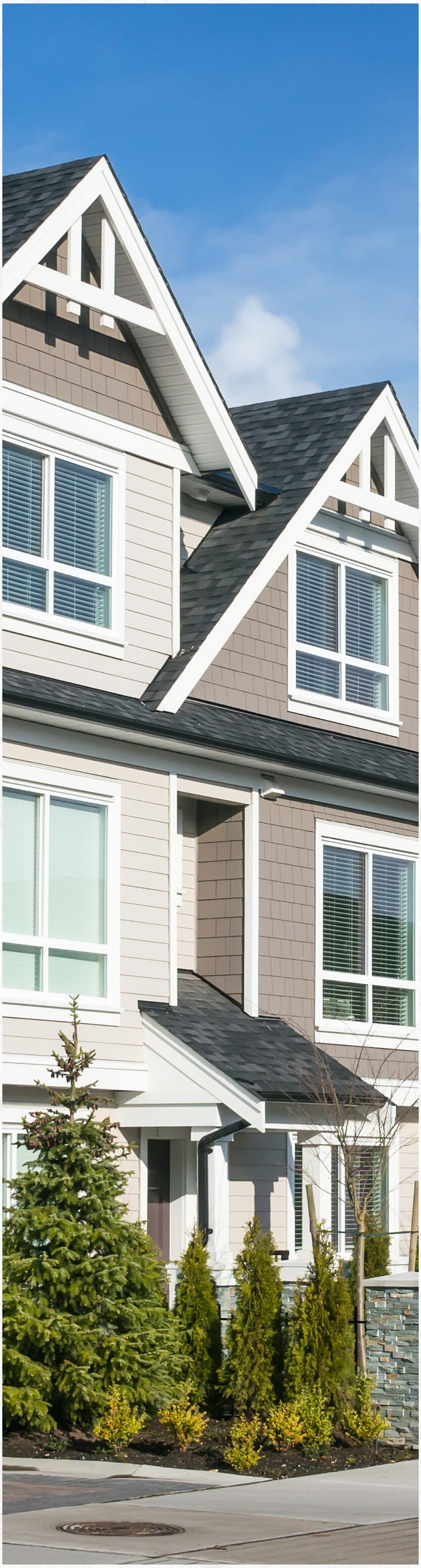

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## *The Importance of Deal Structure*

There's an old adage that says, "the devil is in the details" and this is especially true when owning, operating, and/or investing in multifamily real estate.

For owner/operators, the details of the deal structure have a material impact on the ability to attract investment capital while ensuring that the risk/return profile of the deal meets return criteria. For investors, the details of the deal structure - including fees charged by the manager - have a material impact on the cash available for distribution. So, both parties have a vested interest in a deal's structure to ensure that they both benefit.

The key to creating a good deal structure is to ensure that there is "incentive alignment" for all parties in the transaction. This means that, if the property performs as expected, everyone will benefit by receiving a positive return on their initial investment. For example, a typical multifamily syndication contains an investment "waterfall" whose terms dictate that all investors receive first priority on the property's income and that the owner/operator won't receive any profits until the investors have received a certain return on their investment. In exchange, the owner/operator's share of the income and profits may increase in proportion to the return that they are able to generate for investors. In this structure, the incentives of the investor and owner are “aligned” because they both stand to benefit from the profitable operations of the property.

The details of a project’s deal structure are outlined in the “offering documents”, which should be read completely and thoroughly prior to committing.  As an owner, it is a best practice to write these documents in clear, understandable language and encourage your investors to read them prior to committing their funds to a deal.

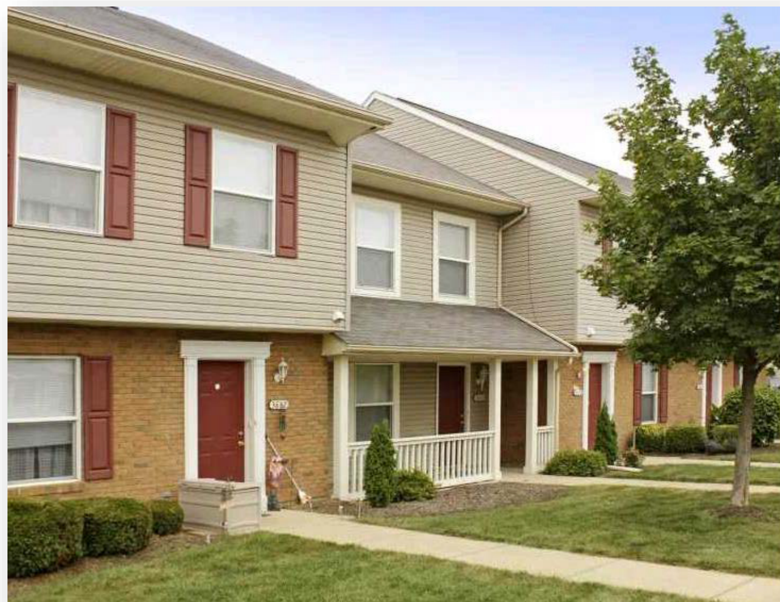
Because deal terms can - and do - vary significantly from one transaction to another, it is important to be familiar with typical structures to understand how they affect returns.  In this document, we are going to review the key concepts found in the typical deal structure, how they work, their pros and cons, and how they impact returns.

To illustrate the concepts, we will use two examples of common structures - the joint venture/partnership and the syndication - and provide a step by step walkthrough to demonstrate how a given structure affects returns.

## ***The Capital Stack***

While there are more complicated varieties, a typical multifamily transaction uses a mix of debt and equity to finance the purchase. Collectively, these financing sources are known as the "**Capital Stack.**"

Each component of the Capital Stack comes with a set of rules that define the priority order of how a property's income is distributed. For the purpose of this document, we are going to discuss two components of the Capital Stack: (1) Senior Debt; and (2) Common Equity.



Senior Debt

Senior debt is most commonly associated with a bank loan and it's often the largest component of the capital stack. Although it varies by deal, a general rule of thumb is to assume that senior doubt will cover 75% of the property's purchase price.

It is called "Senior" debt because the lender that holds it is first in line to receive the property's income. In addition, they can initiate the foreclosure/liquidation process in the event of a loan default and are first to be repaid in liquidation.

## Common Equity

The other major component of the Capital Stack is Common Equity. Holders of Common Equity have an ownership interest, not in the property itself, but in the *entity that owns the property*.

Common Equity holders are last in line to receive property income. In other words, they are only entitled to whatever money is left over after the monthly loan payment has been made. This is a figure called "Cash Available for Distribution" and it represents the pot of money that is to be divided among the common equity shareholders. The same holds true in a bankruptcy/liquidation scenario, which is what makes the Common Equity position riskier than the Senior Debt position. To illustrate this point, consider the following example.

## Capital Stack - A Bankruptcy Example[1]

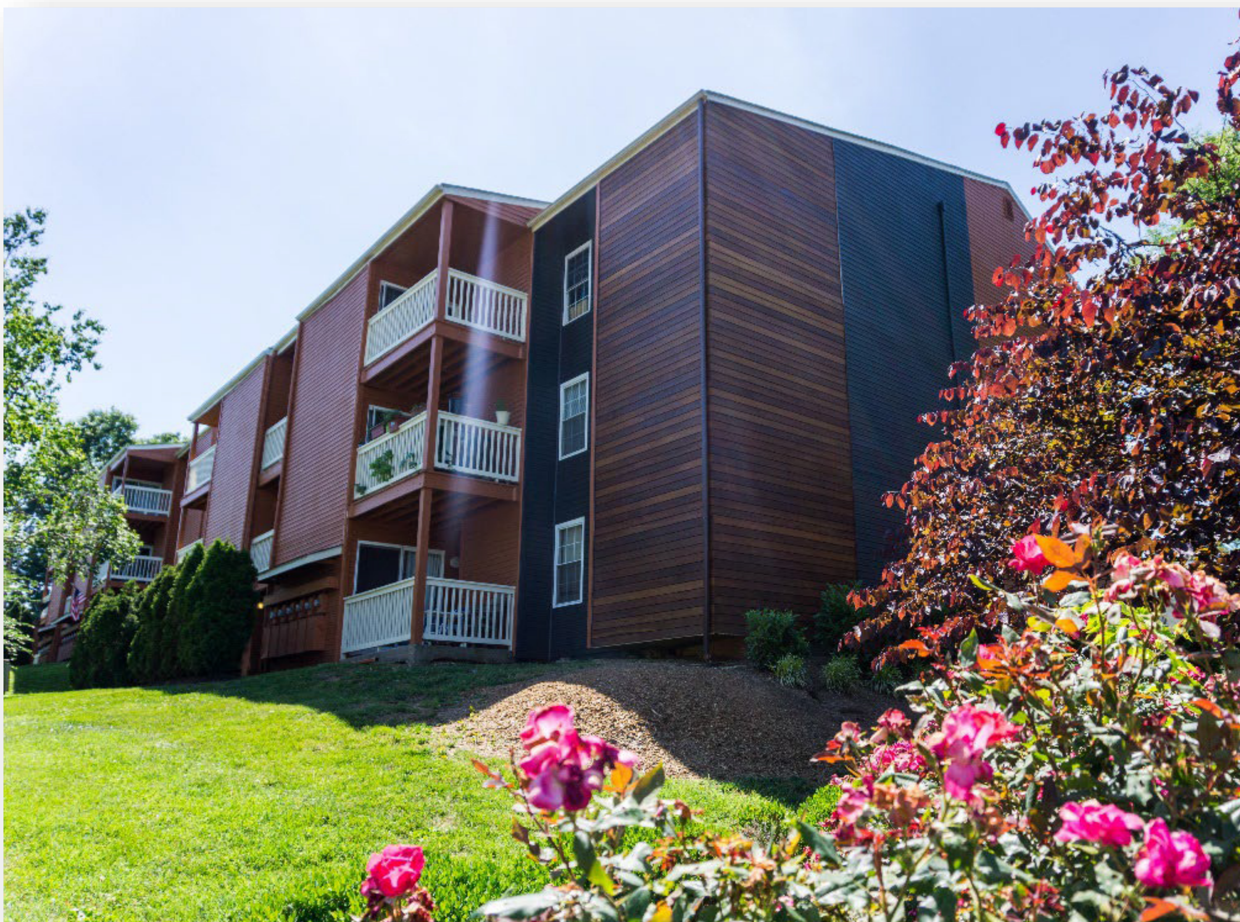
Assume that a property was purchased for $3M dollars. The transaction is financed with $2.25M in senior debt and $750k in equity. The debt is provided by a bank and the equity is provided by a small group of individual investors.

Now, assume that, after two years, the property does not produce enough income to make the loan payments for an extended period. The senior lender forecloses on the property and sells it for $2.5M. The priority order of the capital stack determines who must absorb the loss.

[1] The scenario is simplified for the purposes of the example. It does not include interest that may accrue on the loan or principal reductions made through regular amortizing payments.

With a sale price of $2.5M, the Senior Debt holder is repaid first, and in full, leaving $250k for the common equity holders.  Since they invested $750k in the original deal, they will suffer a $500k loss.

The point is this, when evaluating a deal's structure, the first data point to consider is where your claim sits in the capital stack and what rights/priorities come with it.  As an owner or investor, it is more likely than not that you will be a common equity shareholder.



## *Typical Deal Structures*

In nearly all cases, the entity that purchases the property is a Limited Liability Corporation. Like other corporations, there are shares of stock issued that entitle the owner to a certain percentage of the income produced by the property. The money paid for those shares represents the “Common Equity” portion of the Capital Stack.

There are two common deal structures utilized in multifamily purchase transactions.

### Partnership / Joint Venture

A partnership or joint venture is a business structure where a small number of individuals enter into an agreement to advance their mutual interests. A typical multifamily partnership consists of 2 - 4 individuals who pool their resources to meet the equity requirement in the transaction.

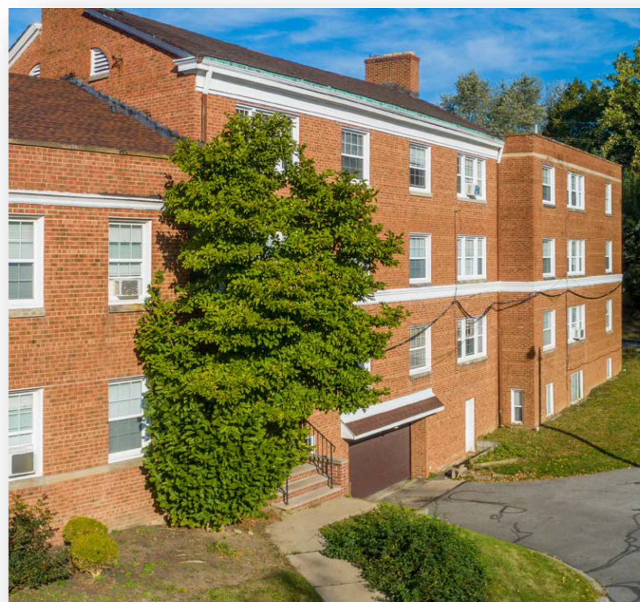
For example, in a transaction that requires $1M in equity, there could be four partners who each contribute $250k. They aren’t contributing the money directly to finance the purchase of the property, rather they are buying shares of ownership in the Limited Liability Corporation that will ultimately purchase the property. As a result, they would each own the representative amount of shares in that entity, which entitles them to that same portion of company profits (25%).

The primary benefit of a partnership is that investors can pool their resources (money and knowledge) to purchase a larger property than they would be able to afford individually.  Other benefits include:  fewer people involved to agree on major decisions, fewer startup costs, fewer reporting costs, and the company can move faster to make major decisions.

The downside of a partnership is that there are fewer people to spread major costs over.  For example, if a major renovation project is required, each partner may have to contribute a significant amount of capital to pay for it.

Partnerships are usually best for experienced investors who have the knowledge and capital to bring significant value to a transaction.

Syndication



In a syndication, the same Limited Liability Company is formed to purchase the property, but the ownership structure is significantly different.

Ownership is usually split into two groups:  the "General Partner" or "GP" and the "Limited Partner(s)" or "LPs."  The GP is the active party and they are responsible for finding the property, arranging the debt *and* equity to finance the purchase, and for managing the asset once the deal has been closed.  The LP is a passive investor and they don't have any say in management decisions.  As a passive investor, they trust the GP with their money and expect that they will get it back - plus interest - at the conclusion of the investment.

Unlike a partnership/joint venture, syndication ownership is not evenly distributed. In most cases, the General Partner will own 20% - 30% of the shares in the Limited Liability Corporation while the remaining shares are owned by the Limited Partner(s). However, the cash flow distribution may not necessarily be in proportion to the percentage of shares owned. In a syndication, the distribution percentages are usually set up so that the General Partner will get a disproportionate share of property income if they manage to meet certain return goals. For example, they may start as a 30% owner, but if they are able to achieve a 15% annual return, they may be entitled to 40% of the property income. This 10% bonus is called the “promote” and it is designed to incentivize the General Partner to manage the property as profitably as possible.

For the GP, the benefit of a syndication is clear, if they manage to meet their return thresholds, they have an opportunity to receive a disproportionately large share of the cash flow pie relative to their initial investment. For a Limited Partner, the benefit of a syndication is that it provides them with an opportunity to invest in a multifamily property and receive all the benefits of ownership without the hassle. In addition, their incentives are aligned with the GP to ensure all parties make as much money as possible.

For the GP, the downside of a syndication is that they require more resources to administer than a partnership. They must source investment capital, create the legal paperwork required to accept investment capital, verify that investors meet minimum requirements, and distribute the necessary tax forms annually.  In short, they are more expensive.  For the LP(s), the downside of a syndication is that they have very little control over the outcome of the investment.  They rely upon the GP's years of experience to deliver a positive return.  In addition, the investment has a long holding period and can be illiquid.

For an investor, a syndication is a good way to enter the realm of multifamily investment.  For an owner, a syndication is a very complex transaction to manage and it requires dedicated attention and resources to ensure success.

## *The Offering Documents*

The Offering Documents contain information about the specific details of the transaction. Often, they are full of dense, legal language that is difficult to read and/or understand.

Depending on the structure of the deal, the Offering Documents may go by different names. They may be called an Owner's Agreement, Operating Agreement, or Prospectus. Regardless of what they are called, there are five key items to look for.

### Owners / Members

The owners or members in the transaction are those that stand to benefit from the profitable operation of the property. Put another way, they are the individuals that hold the common equity in the property ownership entity.

In a joint venture or partnership, the number of owners may be very small, usually between 2 and 4. In addition, the ownership shares may be evenly distributed. For example, in a partnership with two people, the ownership may be 50/50.

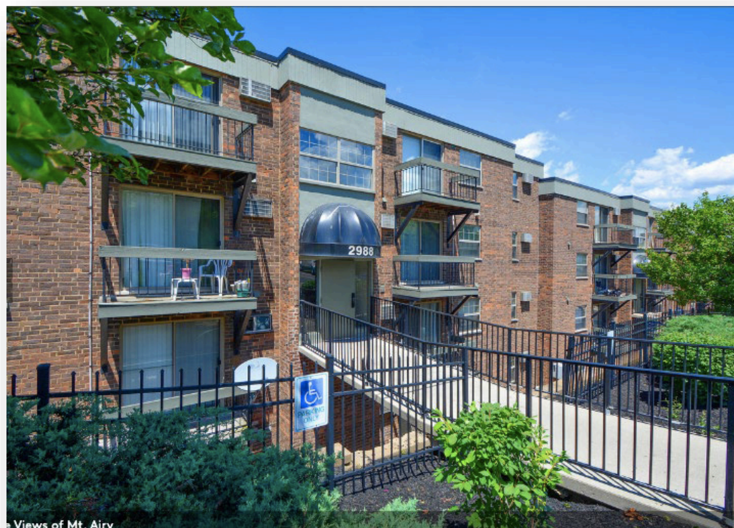
In a syndication, there may be tens or hundreds of holders of common equity, depending on the size of the deal.

The Offering Documents will clearly outline what the entity ownership structure looks like, what percentage each party owns, what their voting rights are, and what their role is in the transaction. These are critical details to consider as they are closely correlated with what percentage of cash flow each party is entitled to.

## Fees

Buying a multifamily property is expensive. You may have to look at dozens of properties before deciding on one to pursue and there are overhead costs associated with this level of effort.

In a partnership or joint venture, you may have to absorb these costs up front and with your own capital. In a syndication structure, you may be able to pass some of these costs on to investors in the form of fees.




Fees are outlined in the Offering Documents. As an owner you will want to be considerate of overcharging investors for fees. In a joint venture or partnership, the costs may have to be borne by the owners as part of their initial investment.

## Capital Calls

Often, we think of a multifamily transaction as one that just needs an injection of capital up front to purchase the property. While this is true in many cases, it isn't true for all of them. On occasion, an unexpected event such as a storm or flood could result in significant property damages. Or, less dramatically, the property may be underperforming and need an injection of capital to keep it afloat.

The offering documents outline the procedure for “capital calls,” which is when the general partner or partner in charge let the other partners know that they need to put in money to pay for something. Regardless of the deal structure, there are consequences to not heeding the capital call and they usually result in a reduction of percentage ownership of the non-compliant party through a process called “dilution.” In essence, the company will issue more shares to be purchased. If you don’t buy them, you now own a smaller percentage of a larger pie.

As an owner, the Capital Call procedure - and consequences for not following them - should be clearly described in the offering documents. As an investor, this is an important clause to look for so you know what to expect should you encounter this event.

### Method for Measuring Returns

Often, the structure of a deal will include certain “hurdles” or “triggers” that impact how the property’s income is distributed. It is important to be aware of exactly what these return hurdles are *and* how they are calculated. The two most common calculation methods are the Internal Rate of Return and the Equity Multiple.

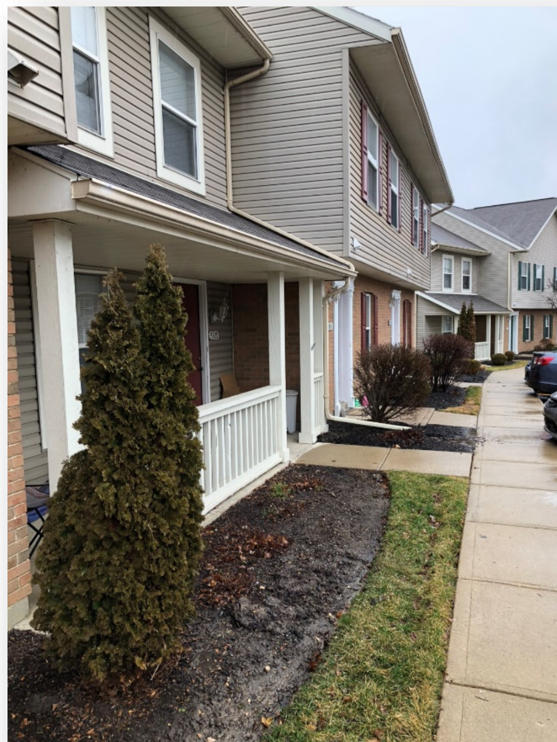
The Internal Rate of Return is the annual discount rate that sets the net present value of future call cash flows, positive and negative, equal to zero.

The Equity Multiple is calculated as the ratio of capital returned to capital invested and it is expressed as a number out to the second decimal position. For example, a $100 investment that returns $150 would result in an Equity Multiple of 1.50X.

As an owner, it is important to define these return calculations for investors so that they can assess their potential return. As an investor, it is important to understand how the return metrics are calculated to assess the risk/return profile of the investment.

## Income Splits

Finally, and perhaps most importantly, the offering documents dictate how the property's income is split between parties to the transaction. In general, the split is heavily dependent upon how the deal is set up.



In a partnership or joint venture, the income split is often "pro rata" meaning that party to the transaction is entitled to an amount equal to the percentage of the acquiring entity owned. For example, if an individual owns 10% of the shares, they could be entitled to 10% of the property income available for distribution in a "pro rata" split.

In a syndication, the split may start as pro rata, but that may change if the property achieves the return hurdles described in the previous section. For example, assume that the General Partner owns 30% of the ownership entity and the Limited Partner(s) own 70%. The offering documents may state that below a 10% IRR, the income split is pro rata, meaning the General Partner will get 30%

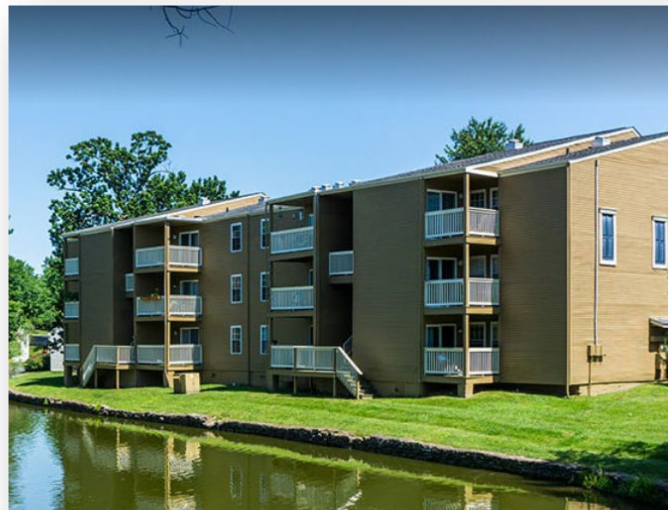
of the income and the Limited Partner(s) get 70%. However, if the IRR exceeds 10%, the cash flow split changes so that the General Partner gets 40% and the Limited Partner gets 60%. This 10% bonus for the General Partner is called a “promote” and it is designed to incentivize them to generate a strong return. However, it comes at the expense of the Limited Partner(s) so this should be considered carefully.

The point is this, the exact details of a deal can vary significantly from one to the next. As such, it is critically important to read and understand the offering documents before committing to a transaction. This goes for the owners who may create the documents and for the investors who may receive them. To illustrate this point, we are going to review two common examples.

## *Scenario Setup*

We are going to use the same example to illustrate how cash flow splits can change depending on three common ownership structures, the partnership, the syndication, and the "sweat equity" structure.

### The Capital Stack



In this example, there is a multifamily property for sale and the contract price is $4M. Senior debt will pay for 75% of the price, $3M, and the remaining funds will come from common equity holders who will contribute $1M.

The senior debt holder is entitled to a first claim on the property's income to cover the monthly loan payments. Any money that is left over is available for distribution to the common equity holders.

### Partnership/Joint Venture Structure

The example partnership has 2 members and they each contribute $500k in cash. In return for their equity contribution, they will each receive a 50% share of the ownership entity. As 50% owners, each member is entitled to 50% of the cash flow that is available for distribution (a pro rata split).

### Syndication Structure

In the syndication structure, there is one General Partner and nine Limited Partners. The General Partner contributes $100k, and the

Limited Partners contribute $900k or $100k per Limited Partner. By virtue of the equity contributions, the General Partner has a 10% share of the ownership entity and the Limited Partner(s) have 90%. The syndication rules state that the General Partner is responsible for the day to day management of the property. The Limited Partner(s) have no say in management decisions. They are strictly passive investors.

The income split in the syndication is a little bit more complicated. ***All*** investors will receive a “preferred return” of 8%, meaning they are entitled to 100% of the property’s income until they have received an 8% return on their investment. Any income over 8% will be split 50/50 between the General Partner and Limited Partner. Hopefully, you see the immediate benefit of this structure for both parties. All stockholders are guaranteed an 8% return. But the General Partner gets half of anything over 8% even though they only contributed 10% of the common equity. Obviously, they will be highly motivated to beat that 8% return hurdle.

### “Sweat Equity” Structure

The “sweat equity” structure is a hybrid of the other two. In this structure, the General Partner contributes **$0** to the transaction and the Limited Partners contribute the entire $1M needed. This scenario is called “sweat equity” because the Limited Partner(s) contribute money and the General Partner contributes their expertise and time to facilitate the transaction.

For their money, the Limited Partner(s) get an 8% preferred return, meaning that they will get 100% of the property’s income available for distribution until they have earned 8% on their money. After that, funds will be split 50/50 between the General Partner and Limited Partner(s).

The benefit of this structure for the GP is obvious, they are into the deal with no money out of their pocket but stand to receive a substantial sum if they can guide the property to a return higher than 8%.

## ***Property Income***

We are not going to cover how to construct the property proforma in this example. Instead, we are going to assume that it has already been created. Cash Available for Distribution is calculated as the property's Net Operating Income minus the payment on the Senior Debt. In addition, we are going to assume that "Year 0" represents the property's acquisition and that the property is sold for $5M in year five. Based on these assumptions, the following table shows the Cash Available for Distribution:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |

The "Year 0" figure represents the combined equity contribution of $1M and the "Year 5" figure represents the regular annual cash flow plus the proceeds of a $5M sale, after the remaining loan balance has been paid off. Because this represents the *Net* Cash Available for Distribution, these are the funds that are available to the shareholders in the ownership entity.

### Performance Metrics

To measure the performance of the investment, we are going to look at three metrics: (1) Internal Rate of Return; (2) Equity Multiple; and (3) Cash on Cash return.

We will look at each of these metrics at both the project level, meaning the property itself, and the investor level, which isn't necessarily going to be the same. These metrics will tell us how each party fared relative to the project and to their initial investment.

## Fees

For simplicity's sake, we are going to assume that the cash flows available are net of fees.  In reality, a General Partner may charge fees to the Limited Partners in a syndication, which may reduce the overall Cash Available for Distribution.

Let's see how each party fared.

## *The Joint Venture / Partnership*

Remember, in the Joint Venture/Partnership, there are two members, each of whom contributed $500k in equity.  For that money, they are each entitled to 50% of the Cash Available for Distribution.  With that in mind, let's see how they fared.

### Cash Available for Distribution

As a refresher, here is the table that shows the Cash Available for Distribution:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| Partner 1: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |
| Partner 2: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |

### Return Metrics

Let's look at the overall return for the property first:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| **Cash on Cash Return:** | - | 11.2% | 11.8% | 12.8% | 13.6% | 284% |
| **IRR:** | 30.80% | | | | | |
| **Equity Multiple:** | 3.33X | | | | | |

The Cash on Cash return is calculated annually as the cash earned divided by the cash invested.  For example, in year 1, the property produced $112k and the initial investment was $1M, so this figure represents a 11.2% return in year 1.  A good Cash on Cash return target is more than 10% annually

The Internal Rate of Return is calculated as the discount rate that sets the Net Present Value of all cash flows equal to zero. In reality, the "IRR' function is used in the spreadsheet to calculate a value of 30.80%, which is strong. A good IRR target is more than 15%.

Finally, the Equity Multiple is calculated as the sum of the total cash produced divided by the amount invested. This project produces an Equity Multiple of 3.33X the initial investment, which is also strong. A good Equity Multiple target is more than 2.0X.

Now, let's see how each partner fared individually:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| Partner 1 Distributions: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |
| Partner 2 Distributions: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |

## Partner 1

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| Partner 1 Distributions: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |
| Cash on Cash Return: | - | 11.2% | 11.8% | 12.8% | 13.6% | 284% |
| IRR: | 30.80% | | | | | |
| Equity Multiple: | 3.33X | | | | | |

## Partner 2

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| Partner 1 Distributions: | ($500,000) | $56,000 | $59,000 | $64,000 | $68,000 | $1,420,000 |
| Cash on Cash Return: | - | 11.2% | 11.8% | 12.8% | 13.6% | 284% |
| IRR: | 30.80% | | | | | |
| Equity Multiple: | 3.33X | | | | | |

It may be redundant to show it, but it can easily be seen that the individual partner returns are the same as the overall project because everything is split 50/50.

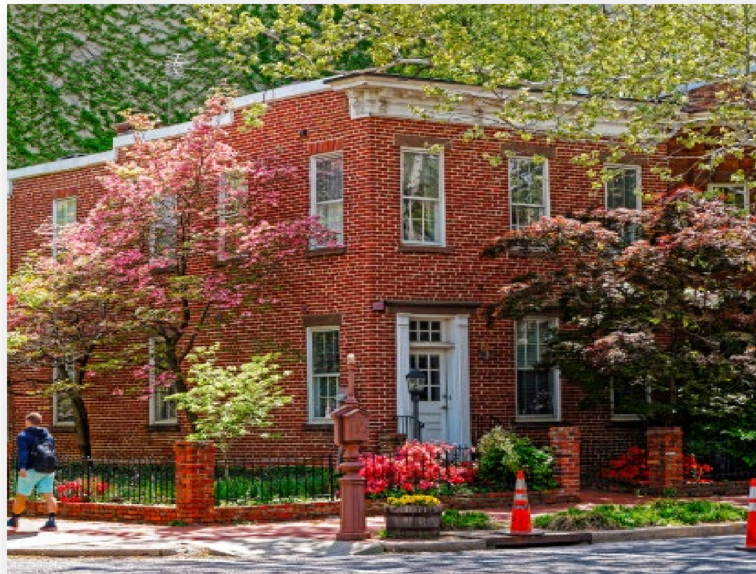
## Partnership Conclusions

A partnership can be a very good investment structure because there are generally a small number of people involved and the benefits of the property cash flow are shared in proportion to the percentage ownership for each partner.

However, partnerships can run into trouble when there is significant disagreement on how to manage the property, over when to sell, or when additional capital is needed and one partner has it, but the other doesn't.  In general, partnerships should be reserved for experienced investors who are well capitalized, have a strong record of working together, and take the time to spell out how the partnership will work in the operating agreement.

## ***The Syndication***

As a refresher, the syndication structure is a bit more complicated. The same $1M in equity is needed up front, but the contributions are different. The General Partner, “GP”, contributes 10% or $100k and the Limited Partner(s), “LPs”, contribute 90% or $900k. There are nine LPs, each of whom contribute $100k.



The cash distribution structure is also a bit more complicated. All stockholders will receive 100% of the property income on a pro-rata basis until they have received an 8% preferred return on their contribution. But above 8%, the remaining income is split 50/50 between the GP and LPs.

Let’s see what that looks like. We should note that the math here can get complicated and this is not meant to be a presentation on cash flow modeling. The calculations will not be discussed in detail, except to the extent necessary.

## Cash Available for Distribution

In the syndication, the cash available for distribution is the same, but the split is very different.  Here is what the first "step" looks like:

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| | | | | | | |
| LP Capital Account Beginning Bal. | $0 | $900,000 | $871,200 | $834,696 | $786,272 | $726,773 |
| LP Required Return (8% Pref.) | - | $72,000 | $69,696 | $66,776 | $62,902 | $58,142 |
| LP Contributions | $900,000 | $0 | $0 | $0 | $0 | $0 |
| LP Distributions | - | $100,800 | $106,200 | $115,200 | $122,400 | $784,915 |
| LP Capital Account Ending Bal. | $900,000 | $871,200 | $834,696 | $786,272 | $726,773 | $0 |
| | | | | | | |
| GP Capital Account Beginning Bal. | $0 | $100,000 | $96,800 | $92,744 | $87,364 | $81,753 |
| GP Required Return (8% Pref.) | - | $8,000 | $7,744 | $7,420 | $6,989 | $6,460 |
| GP Contributions | $100,000 | $0 | $0 | $0 | $0 | $0 |
| GP Distributions | - | $11,200 | $11,800 | $12,800 | $13,600 | $87,213 |
| GP Capital Account Ending Bal. | $100,000 | $96,800 | $92,744 | $87,364 | $81,753 | $0 |
| | | | | | | |
| **Cash Flow Remaining** | **$0** | **$0** | **$0** | **$0** | **$0** | **$1,967,872** |

Upon completion of "step 1" all investors have received a preferred return of 8% on their initial investment.  But, with that return, there is still $1.96M left to be distributed after the sale of the property. Remember, this will be split 50/50 between the GP and the LP. Here is that the second step looks like:

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| **Cash Flow Remaining** | $0 | $0 | $0 | $0 | $0 | $1,967,872 |
| Distributions to LP: | $0 | $0 | $0 | $0 | $0 | $983,936 |
| Distributions to GP: | $0 | $0 | $0 | $0 | $0 | $983,936 |

With all the cash distributed, let's see how each group fared. From the previous section, we already know that the project has an IRR of 30.8% and an Equity Multiple of 3.33X.

## Limited Partners

To summarize, here is what all distributions to the Limited Partner's look like (**NOTE**: Year 5 includes the proceeds from the sale of the property):

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| **LP Cash Flows** | ($900,000) | $100,800 | $106,200 | $115,200 | $122,400 | $1,768,851 |
| Cash on Cash Return: | - | 11.2% | 11.8% | 12.8% | 13.6% | 196% |
| IRR: | 22.86% | | | | | |
| Equity Multiple: | 2.46X | | | | | |

From this table, we can see that the Cash on Cash return is very similar to the project level returns. However, both the IRR and Equity Multiple underperform the project. The reason is that, in exchange for an 8% preferred return, they agree to give up a portion of their income to the GP as a reward for generating a good return. Let's see how that looks.

## General Partner

Again, the table below summarizes the GP distributions, which also include their half of the sale proceeds in year 5:

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| **GP Cash Flows** | ($100,000) | $11,200 | $11,800 | $12,800 | $13,600 | $1,071,149 |
| Cash on Cash Return: | - | 11.2% | 11.8% | 12.8% | 13.6% | 1,071% |
| IRR: | 66.22% | | | | | |
| Equity Multiple: | 11.20X | | | | | |

Here is where the power of the syndication can be seen for the General Partner.  They only contributed 10% of the equity needed, but they got 50% of the sale proceeds because they met the return hurdle.  As a result, their return is significantly higher than the LPs, which is most clearly demonstrated in the Equity Multiple of 2.46X for the LP and 11.20X for the GP.

## Syndication Conclusions

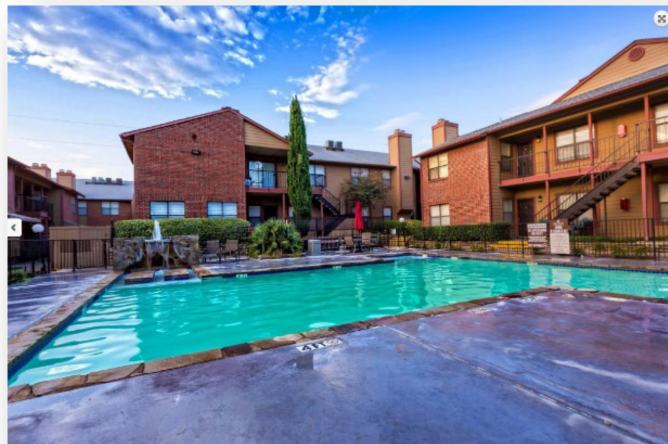
The syndication structure can be incredibly lucrative for the General Partner *if* they are able to operate the property successfully and guide it to a profitable sale.  The reason it can be so lucrative is the typical syndication structure provides a disproportionate split of Cash Available for Distribution once a defined return hurdle has been met.

In this example, the Limited Partners did well - they made 2.46X their money - so they are happy.  But the General Partner did *really* well because they were able to beat the return hurdle and increase their share of the income to 50% of everything after the 8% return was achieved.

## ***The Sweat Equity***

Remember, this scenario is so named because the General Partner put in $0 of the required equity.  Instead, they put in their time and expertise (their "sweat) to find the property and assemble the transaction.  The Limited Partners put in the entire $1M.

In return, the Limited Partner(s) are entitled to an 8% preferred return on their money, meaning that they get 100% of the cash available for distribution until they have received said return. Above 8%, the remaining cash is split 50/50 between the General Partner and Limited Partner(s).



Again, the benefit for the General Partner in this structure is obvious, they don't have to front any money.  Instead, they rely on their knowledge and operational expertise to facilitate the transaction. The benefit for the Limited Partner(s) is that they get a preferred return, giving them first priority on the property's income. Let's see how each party fared.

## *Cash Available for Distribution*

The cash available for distribution is the same as the other scenarios, but it is split differently.  See the table below for details:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| | | | | | | |
| LP Capital Account Beginning Bal. | $0 | $1,000,000 | $968,000 | $927,440 | $873,635 | $807,525 |
| LP Required Return (8% Pref.) | - | $80,000 | $77,440 | $74,195 | $69,890 | $64,602 |
| LP Contributions | $1,000,000 | $0 | $0 | $0 | $0 | $0 |
| LP Distributions | - | $112,000 | $118,000 | $128,000 | $136,000 | $872,127 |
| LP Capital Account Ending Bal. | $1,000,000 | $968,000 | $927,440 | $873,635 | $807,525 | $0 |
| **Cash Flow Remaining** | **$0** | **$0** | **$0** | **$0** | **$0** | **$1,967,872** |
| | | | | | | |
| LP Step 2 Proceeds | $0 | $0 | $0 | $0 | $0 | $983,936 |
| GP Step 2 Proceeds | $0 | $0 | $0 | $0 | $0 | $983,936 |

Earlier, we mentioned that the primary benefit of this structure should be clear for the GP, they can get in the deal with no money out of their pocket.  But, looking at this table should highlight the other side of this coin.  The GP may have to wait for 5 years to see any return on the deal.  Although they didn't put any money directly into the deal, they will have to pay the salaries for the asset managers that are needed to support this property for 5 years.  So, it is far from "free" for the GP.  Here's a summary of the cash flows for both parties:

| **Year** | **0** | **1** | **2** | **3** | **4** | **5** |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| LP Distributions: | $0 | $112,000 | $118,000 | $128,000 | $136,000 | $1,856,063 |
| GP Distributions: | $0 | $0 | $0 | $0 | $0 | $983,936 |

Limited Partners

Let's see what the investment return metrics look like for the Limited Partner(s):

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| LP Distributions: | $0 | $112,000 | $118,000 | $128,000 | $136,000 | $1,856,063 |
| IRR: | 21.70% | | | | | |
| Equity Multiple: | 2.35X | | | | | |

The Limited Partner(s) return looks like the syndication scenario, but the IRR and Equity Multiples are slightly lower given their higher initial investment. The IRR of 21.70% and the Equity Multiple of 2.35X are strong returns for the LP, but they also have to pay a high price to the GP once they have reached their 8% return hurdle.

General Partner

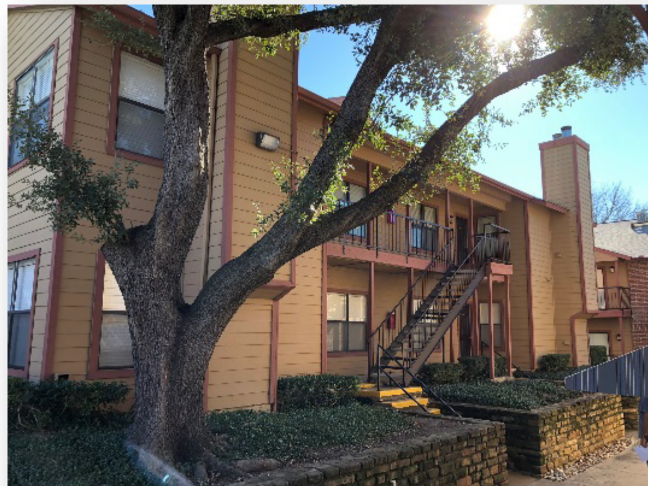
The table below summarizes the GP's distributions:

| Year | 0 | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|---|
| Cash Available for Distribution | ($1,000,000) | $112,000 | $118,000 | $128,000 | $136,000 | $2,840,000 |
| GP Distributions: | $0 | $0 | $0 | $0 | $0 | $983.936 |
| IRR: | 1,479% | | | | | |
| Equity Multiple: | 983,936X | | | | | |

The IRR and Equity Multiple aren't the best return metrics for the GP because they didn't put any money in, which can skew the numbers extremely high. For the sake of argument, if we assume they put in $1 and their resulting IRR is 1,479% and the Equity Multiple is 983,936X.

## Summary & Conclusions

This is a unique structure. It can be incredibly beneficial for the GP, but it isn't without risk and it shouldn't be attempted by first time GPs. It is a structure for established GPs who can leverage a long track record of operational expertise, management success, and investor contacts to negotiate such a deal for themselves. In addition, the GP must have the financial resources to support the property for multiple years before they ever see any sort of return.



For the LP, they get the benefit of the 8% preferred return and the stability of working with an experienced GP. But it comes at a big price. They must give up half of the cash available for distribution once the property return has exceeded the 8% threshold.

## *Summary & Conclusions*

The overall takeaway from this presentation should be clear, the details of a deal structure matter. As an investor or owner, they may make the difference between a good return or a great return. They also define who is responsible for funding operating deficits should the property not perform as expected. This could be the difference between a bad loss or a really bad loss.

Details of the deal structure are outlined in the offering documents. As an owner, they should be written clearly and concisely so that potential investors can understand the risks and benefits of the transaction. As an investor, they should be read and scrutinized in detail to be comfortable with the split between the parties to the transaction. Special attention should be paid to the members in the transaction, the fees charged, calculation methodology for the return metrics, and the cash flow split for each step.

The devil is truly in the details and mastering them will accelerate your path to success.