ASHCROFT CAPITAL

Understanding Real Estate

PRIVATE PLACEMENTS

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- **ASH PATEL,** PASSIVE INVESTOR

ASHCROFT CAPITAL

Ashcroft Capital is a national multifamily investment firm with over $1,000,000,000 of assets under management. Ashcroft is focused on major metropolitan statistical areas (MSA’s) which demonstrate consistent rent growth, low vacancy and a growing Real GDP. Established as a premiere multifamily boutique firm with nimble investment sourcing, structuring, execution and asset management capabilities. Ashcroft is a highly skilled and deeply focused real estate investment manager with the flexibility to scale and cater to investor preferences.

About This Guide

The sole purpose of this guide is to help you to make informed decisions when investing in real estate private placements.

For your convenience, the guide is categorized into three sections:

FIRST, we explain private placements.

SECOND, we explain some commonly used terms in real estate private placements along with some examples of how such terms are used.

THIRD, we share some questions to ask with respect to a private placement, the market in which the deal is located, the general partner and the team that will implement the business plan.

1.
What are Private Placements?

What Are
Private Placements?

Simply put, a private placement is the private sale of unregistered securities to a group of investors rather than on the public market. Private placements enable issuers to raise capital without registration with the SEC, relying on certain exemptions from registration under the securities laws. Entities engaging in private placements can be in any industry, including real estate.

Under the U.S. securities laws, an offering of securities must be registered with the Securities and Exchange Commission (the "SEC") A private placement is a securities offering that is exempt from registration with the SEC, so long as the issuer complies with certain criteria.

Generally speaking, private placements maintain different requirements than those of public offerings and must comply with the criteria specified in Rule 506 of Regulation D under the U.S. Securities Act of 1933, the safe harbor for what constitutes a private offering. Irrespective of any available exemption with regard to offers and sales of securities, there is no exemption from federal and state anti-fraud rules.

Here is the overall process for how a real estate private placement generally work:

The sponsor identifies certain real property (the "**Property**") for acquisition and forms the general partner entity (the "**General Partner**" or "**GP**"). The General Partner, in turn, forms a limited partnership (the "**Partnership**") and either directly or indirectly acquires the Property. In order raise capital to facilitate with acquisition, the management, and often the construction and renovation of the Property, the Partnership, through its General Partner, offers the opportunity to invest in the Partnership to accredited investors by acquiring limited partnership interests in the Partnership ("**LP Interests**") under the exemption from the registration provisions of the Securities Act of 1933, as amended ("**Securities Act**"), provided by Rule 506 of Regulation D.

What types of properties do real estate private placments invest in?

Assuming that investing in real estate via private placements is of interest to you, the next step is to determine the type of real estate offering to invest in.

Distressed Property

Can include: a non-stabilized apartment community, which means the economic occupancy rate is below 85% (and likely much lower), due to poor operations, tenant problems, outdated interiors, amenities, mismanagement or deferred maintenance.

Typically, investments via private placements in which the issuer acquires distressed properties, offer little to no ongoing cash flow, but can provide the potential of a greater overall return with a greater risk of investment loss.

New Development

Can include: the purchasing of vacant land (or land with an existing structure that will be knocked down) and constructing of a brand-new apartment community from scratch.

Typically, investments via private placements in which the issuer acquires land for new developments offer little to no ongoing cash flow and have a greater risk of investment loss, but can provide the potential for a greater overall return.

Value-Add Property

Can include a stabilized apartment community with an economic occupancy rate above 85% which has the opportunity to be improved by making improvements to the operations and the physical property through exterior and interior renovations in order to increase the income and/or decrease the expenses.

Typically, investments via private placements in which the issuer acquires stabilized apartment properties, offers medium to high ongoing cash-on-cash return and medium to high potential profit at the end of the business plan with a lower risk.

2.
Important Terminology

General Terminology

The following terms will help you become well versed in real estate private placements.

ACCREDITED INVESTOR

—

An accredited investor is an investor that is permitted under the Securities Act to invest in certain securities because they meet certain income and asset criteria, as set forth in Rule 501 of Regulation D, available here.

PRIVATE PLACEMENT

—

Under the federal securities laws, a company may not offer or sell securities unless the offering has been registered with the SEC or an exemption from registration is available. A securities offering exempt from registration with the SEC is sometimes referred to as a private placement or an unregistered offering.

Generally speaking, private placements are not subject to some of the laws and regulations that are designed to protect investors, such as the comprehensive disclosure requirements that apply to registered offerings. Private and public companies engage in private placements to raise funds from investors. Private placements can be very risky and difficult to sell.

NET OPERATING INCOME (NOI)

—

Net operating income (NOI) is the income from the property minus operating expenses, excluding capital expenditures, debt service, depreciation and amortization.

For example, a 216-unit apartment community with a total income of $1,879,669 and total operating expenses of $1,137,424 has a NOI of $742,245.

CAP RATE

—

Capitalization rate, typically referred to as cap rate, is a measure of valuation. In general (although there are variations) a cap rate is calculated by dividing the property's NOI by either the current market value or acquisition cost of a property (cap rate = NOI / Current market value). For example, a 216-unit apartment community with a NOI of $742,245 that was purchased for $12,200,000 has a cap rate of 6.1%.

GENERAL PARTNER

—

The general partner of a partnership is the person or entity that has managerial control and authority over the partnership's business and its assets. The general partner typically maintains liability for the actions, expenses and debts of the partnership.

LIMITED PARTNER

—

The limited partner of a partnership is a person or entity that has limited management and control of the partnership's business and assets. The limited partner's liability is generally limited to the extent of its financial contribution or investment in the partnership. A limited partner is not responsible for the debts of the partnership.

SPONSOR

—

The sponsor identifies the real property for acquisition and forms the general partner entity. Many sponsors also provide services to the Property such as marketing, management and renovations.

BREAKEVEN OCCUPANCY

—

Breakeven occupancy is the sum of all the operating expenses, including debt service, of the property divided by the gross potential income. For example, a 216-unit apartment community with $1,166,489 in operating expenses, $581,090 in debt service and $2,263,624 in gross potential income has a breakeven occupancy of 77.2%).

GROSS RENT MULTIPLIER

—

The gross rent multiplier ("GRM") is the number of years the apartment would take to pay for itself based on the gross received rent ("GPR"). The GRM is calculated by dividing the purchase price by the annual GPR. For example, a 216-unit apartment community purchased for $12,200,000 with a GPR of $183,072 per month has a GRM of 5.6.

GROSS POTENTIAL INCOME

—

The gross potential income is the hypothetical amount of revenue if the apartment community was 100% leased year-round at market rates plus all other income. For example, a 216-unit apartment community with a GPR of $183,072 and monthly other income of $14,153 from late fees, pet fees and a RUBS program has a gross potential income of $197,225 per month.

INTERNAL RATE OF RETURN (IRR)

—

The internal rate of return ("IRR") is representative of the intrinsic rate of return that is expected to be derived from a particular investment, taking into account the amount and timing of the associated cash flows.

The IRR is the rate that makes the net present value ("NPV") equal to zero. NPV is the difference between the present value cash inflows and the present value of cash outflows over a period of time. For real estate private placements, NPV is the difference between the cash flow generated by and the equity invested into the investment.

A very simple example is as follows:
Let's say that you invest $50 in an investment. The investment has cash flow of $5 in year 1, and $20 in year 2. At the end of year 2, the investment is liquidated and the $50 is returned. The total profit is $25 ($5 year 1 + $20 year 2). Simple division would say that the return is 50% ($25/50). But since time value of money (two years in this example) impacts return, the IRR is only 23.43%. If we had received the $25 cash flow and $50 investment returned all in year 1, then yes, the IRR would be 50%. But because we had to "spread" the cash flow over two years, the return percentage is negatively impacted.

The timing of when cash flow is received has a significant and direct impact on the calculated return. In other words, the sooner you receive the cash, the higher the IRR will be.

RENT ROLL

—

The rent roll is a document or spreadsheet containing detailed information on each of the units at the apartment community, along with a variety of data tables with summarized income.

PRO-FORMA

—

A pro-forma is the projected budget of an apartment community with itemized line items for the income and expense for the next 12 months and 5 years, which is an output of the underwriting.

UNDERWRITING

—

Underwriting is the process of financially evaluating an apartment community to determine the projected returns and an offer price.

RENT PREMIUM

—

A rent premium is the increase in rent after performing renovations to the interior or exterior of an apartment community. The rent premium is an assumption made by the General Partner during the underwriting process based on the rental rates of similar units in the area or previously renovated units.

3. Questions to Ask of a General Partner

Questions

The questions to ask the general partner (GP) fall into four categories:

1. INVESTMENT STRATEGY FAQS:

Questions to ask the GP to gain an understanding of their overall investment strategy and process.

2. SPECIFIC DEAL FAQS:

Questions to ask the GP about a specific deal they have under contract and are raising money for.

3. MARKET FAQS:

Questions to ask the GP about the market in which they are investing.

4. TEAM FAQS:

Questions to ask the GP to learn the qualifications of them and their team.

BE PROACTIVE

The purpose of this section is to make you aware of the types of questions to ask and information you need in order to make an educated investment decision. Ideally, the General Partner will proactively answer these questions when they are presenting a new deal.

> "I'VE TRIED OUT MANY DIFFERENT TYPES OF INVESTMENTS. I LIKE INVESTING WITH ASHCROFT FOR A COUPLE REASONS. NUMBER ONE, JOE TALKS TO PEOPLE PERSONALLY, BEFORE YOU INVEST; AND TWO, HE'S GOT SKIN IN THE GAME. HE'S ACTIVELY INVESTING ALONGSIDE OF ME. BOTH OF THE DEALS THAT I'M IN WITH HIM, THEY'VE DONE WELL OR BETTER THAN EXPECTED."
>
> - JEFF ANZALONE,
> PASSIVE INVESTOR

1. Investment Strategy FAQs

What type of reporting do the investors receive?	An investment's partnership agreement specifically discusses when limited partners receive information regarding the Partnership. Once the deal is closed, the General Partner should send consistent updates on the status of the deal. You may receive updates once a month, however, some General Partners provide quarterly updates and others provide annual updates. Some may not provide updates at all. The information included in the update varies depending upon who is the General Partner. Our monthly reports include occupancy rates, updates on the number of renovated units, details on our rental premiums and how they compare to our projections, capital expenditure updates, relevant updates on the market and resident events. Overall, you want to know the status of the business plan and how the rents compare to the projections.
Do you guarantee a return?	General partners should not guarantee a return. Returns are projections, not promises. Furthermore, any returns, including any potential coupon amounts or preferred returns, are typically subject to the discretion of the General Partner and the availability of cash.
What are the major risk points for this project?	Investing in real estate private placements involves significant risks. Review all investment materials carefully to be sure you understand these risks.
How long do I have to keep my money in the investment?	Before making an investment, the General Partner should provide you with a projected timeline, which includes the hold period and the exit strategy of the investment. Generally, the General Partner will require you to keep your capital in the investment until the asset has been sold or disposed.

1. Investment Strategy FAQs (cont.)

Can I pull out my investment?	This varies. But if there is a process for pulling your money out of the deal, it will be outlined in the PPM and the Partnership Agreement. The process usually entails the sale of your shares to another party with the written consent of the General Partner.
How do you make money?	Generally, the GP will earn an acquisition fee, a fee for ongoing asset management, its equity ownership in the investment will provide it with a return, among other potential fees. All of the fees a GP charges should be listed in the PPM.
How frequently do I get paid?	The distribution frequency varies and depends on the preference of the General Partner and what their team is capable of doing from an administrative standpoint. The General Partner generally maintains the sole discretion to cause a distribution. The typical frequencies are monthly, quarterly or annually, 45 days after the end of the applicable period. For example, if you receive monthly distributions, you would receive the distribution for March at the end of April. After a sale of the asset, you may receive your initial equity investment plus profits from the sales proceeds.
What is the minimum investment?	Most GPs will have a minimum investment. The more experience the General Partner has and the larger the project, the higher the minimum. You want to know what the minimum investment is so that you can determine if you are financially capable of investing in the deal.

2. Specific Deal FAQs

Why is the owner selling?	For value-add real estate private placements, the majority of owners are selling because they've reached the end of their business plan. But, some owners may sell because they are distressed in some form.
Is the property being acquired below comparable properties in the area?	The combination of the costs associated with purchasing the property and the capital expenditure costs should be lower than the value of comparable properties in the area.
What is the going-in cap rate?	The going-in cap rate is based on the purchase price and the current net operating income. You want to know the going-in cap rate so you can compare it to the rate in the market. A going-in cap rate that is higher than the market cap rate is a good sign, because that means the property is purchased below market value.
What's the status of the major systems, like the plumbing, roofs, and HVAC?	Understanding the quality of the major systems is important for the General Partner to determine an exterior capital expenditures budget. Additionally, if the major systems are in bad shape, this is a risk factor and should be addressed with a contingency budget. The only way to know the true state of the major systems is for the General Partner to ask them if they or someone on their team inspected these major systems themselves and see them with their own eyes, as opposed to trusting the owner or the real estate broker.
What is the breakdown of the capital expenditures budget?	The General Partner shouldn't just provide you with an overall capital expenditures (CapEx) budget. You want to know how much money is budgeted to each project. Also, you want to know how they calculated the CapEx budget. More specifically, you want to know if the General Partner assumed the CapEx costs or if they are based on bids from contractors who inspected the property. The latter is more accurate than the former. Finally, you want to know what portion of the CapEx goes towards a contingency fund. The contingency should be 10% to 20% of the total CapEx costs.

2. Specific Deal FAQs (cont.)

How do the year 1 income projections compare to the trailing 12-month financials?

If the year 1 income projections are different than the actual trailing 12-month financials (T12), you want to know why. The revenue is based on market rents, loss to lease, vacancy loss, bad debt, concessions, employee and model units and other income. So, if any of these line items differ from the T12, you want to know what the General Partner based those assumptions on and whether or not those assumptions were approved by the property management company.

If the General Partner is a value-add investor, then the T12 will always differ from the year 1 projections because the market rents are being increased.

What assumptions are being used to calculate the annual taxes?

You want to know if the annual tax assumption is based on what the current owner is paying or if it is based on the purchase price.

The tax assumption can be calculated by finding the tax rate on the county's auditor site and multiplying it by the projected purchase price.

What annual income growth factor is being used?

We believe a conservative annual gross potential income growth factor is between 2% to 3% after stabilization. This factor is the projected natural growth in revenue.

Some General Partners will base this factor on historical rent growth, which may be lower or higher than 2% to 3%. Rent growth factors of 4% or higher are aggressive and if you run into such a case, the General Partner should have ample evidence to explain why they've assumed a higher number.

3. Market FAQs

How do you qualify a market?	You want to know what market factors the General Partner looks at when qualifying a market. Important factors include unemployment change, population growth, population age, job diversity, the top employers and supply and demand.
How is the school district?	One of the factors a prospective tenant will take into account when moving to an area is the quality of the school district. Even if the target tenant demographic are not small families, a quick way to gauge the overall quality of a market is the school district. Look at the elementary, middle and high schools and see how they rank. A website to find information on the quality of the local school district is GreatSchools.org.
Are there any crime issues?	Look at the crime stats for the market. If there is a specific deal, look at the crime stats of the neighborhood. More specifically, look at the crime trend. Even if it is relatively high, a downward trend is a good sign. A good resource for crime statistics is CityProtect.com.
What is the median income?	You want to know the median income of the area in order to determine if the demographic's income levels support the rent projections. Generally, people spend 25% to 35% of their annual income on home expenses. Therefore, confirm that the median income is at least 3-4 times higher than the annual projected rent. The United States Census Bureau keeps details data on median incomes across the country.
What is the market vacancy rate?	The market vacancy rate is essentially the average multifamily vacancy rate in the market. However, a more accurate market vacancy rate is based on a handful of recent sales. Ask them what the market vacancy rate is and how it was calculated, and then compare that rate to the assumed vacancy rate for the specific deal.

3. Team FAQs

What is your experience?	Determine how many deals they have completed and how those deals actually performed when compared to the projected returns. If the sponsor has had past deals that underperformed when compared to the projections, it isn't necessarily a deal breaker. A good follow up question would be "what processes have you put in place to reduce the likelihood of an underperforming deal?" You may want to take into consideration whether a sponsor has successfully taken a deal full cycle. While this can be offset by an experienced team, there is still more risk when going with a sponsor who does not have a proven track record.
Do you currently have any real estate assets under contract?	This is a question you would want to ask during your first conversation with a General Partner. If they have a deal under contract, ask them some of the questions outlined in the "Specific Deal FAQ" section. You will have a better understanding of their business plan when they explain it for an actual deal than for a hypothetical deal. Also, if they currently have a real estate asset under contract, ask them how much capital they have left to raise.
What are <u>your</u> responsibilies?	Generally, the General Partner will find the real estate asset, review and qualify the deal via underwriting, make and negotiate the purchase offer, coordinate with professional property inspectors, find the best financing options, coordinate with attorneys to create the ownership entities and partnership agreements, travel to the property to perform due diligence and market research, hire and oversee the property management company and perform ongoing asset management, which includes lender conversations, oversee the business plan and communicate with investors and stakeholders.

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