Case Study: How I Lost My Sleep Over My First attempt at a Real Estate Syndication Project

Case Study

Abstract

If you are just starting out in the world of real estate investing as a syndicator or doing joint venture with others, you may potentially benefit from this case study as it contains twelve valuable lessons learned.

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My Background and Mini-Biography

I was born in and immigrated from what used to be the Soviet Union, now Ukraine. When I arrived in the United States at 20 years of age, I knew that I was not entitled to anything except an adventure, and that in order to succeed I had to work hard and learn harder. I pursued a degree in Accounting from Baruch college (part of City University of New York), while working to support my mom and me. In addition to my bachelor's degree in Accounting I hold an MBA in Finance and Management from Rutgers University. I am a former tax accountant with the Big Four experience. I later switched to the technology industry and worked in various roles, mainly as a liaison between business and technology teams.

After I married and our family started to grow, one of my primary concerns about my family's savings has been the over-concentration in Wall Street investments. In fact, aside from our home and two investment condos our portfolio was entirely in aggressive stocks. I have seen a number of significant stock market corrections and crashes in my lifetime. Therefore, I set out to find the best way to diversify our portfolio into alternate investments that would be independent of Wall Street cycles, with the end goal to preserve my family's wealth while saving on taxes.

☜ TIP ☞

Take a couple of minutes to refresh your memory by watching a short video titled "How do I Diversify my Investment Portfolio?" about the types of alternate investments and their financial benefits.

Real estate has been on my mind for years. As I conducted extensive research, it led me to the world of real estate syndications. I started out as a passive investor, aka an equity partner in real estate deals, and I quickly realized the benefits of this passive investment strategy. Real estate syndication was both: opportunity-laden and conservative at the same time. Not only did it allow me to preserve wealth, but it was a way to do it absolutely passively, while taking advantage of tax benefits. I realized that likeminded individuals, such as myself would be interested in these investment benefits.

Out of this idea, my business was born – SAMO Financial LLC. I started my own boutique private equity company, whose mission is to help a select group of highly compensated professionals and entrepreneurs to increase their wealth passively while utilizing tax-saving strategies. So today, I concentrate on helping successful professionals and business owners that seek to preserve and multiply their wealth but don't necessarily have the bandwidth to do it. I mentor and coach them on how to become successful passive real estate investors, teach them recession-resistant passive real estate investing strategies, as well as help them to invest in asset classes that are counter-cyclical to negative swings in the economy.

Case Study Introduction

In 2017 a friend introduced me to their acquaintance – we will refer to this acquaintance as Pete (all names have been changed for privacy reasons). Pete was a well-known local construction business owner and house flipper in one of the Midwest states. Pete's most recent real estate investment project was somewhat different than his usual modus operandi – this time it was a longer-term ownership of a multi-unit apartment project, and Pete was searching for syndication partners. Up to that point I had only invested as a Limited Partner (LP), so I was excited for this opportunity to finally step into a General Partner (GP) role and ramp up my syndication investment experience. I proceeded into performing due diligence of both, Pete and the deal he was offering. This specific deal gave me invaluable hands-on General Partner and syndication know-how and real-life asset management, as well as contract negotiation expertise that enabled me to vastly improve my skillset.

In this case study, I am going to go over the series of relatively minor initial missteps that later snowballed into a near-catastrophe experience. I will describe how I was able to pull the project from the brink of disaster and make it a success.

General Background Information

☜ TIP ☞

If you are reading this case study, you may be familiar with the term, Real Estate Syndication. But if you are new to investing in Real Estate through Syndications or if you would like a refresher, these short educational videos – What is Syndication?*,* How do I Become a Passive Syndications Investor?*,* How Does the Syndication Process Work?*, and* What are Syndication Fees? *– will bring you up to speed.*

Partnership Members

GP relationships in our partnership were rocky from the start, but I chucked up my misgivings to normal startup bumps in the road. Although my gut feel was to walk away; I decided to stick it out.

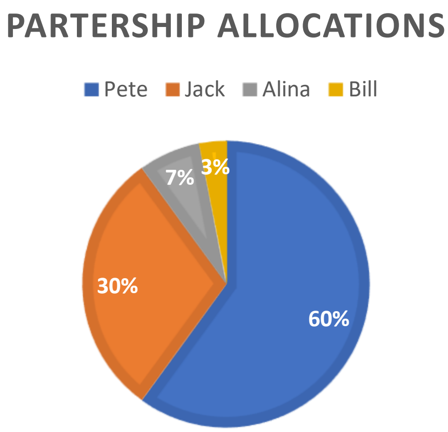
⚠ Caution ⚠

Always trust your gut! As you analyze this business case, you will see that when something feels wrong it usually indicates a potential risk to the investment. Of course, you may not be hundred percent correct in all the cases. However, trusting your gut feel is something that has been commonly referred as trusting your intuition when making important decisions.

In fact, our third partner, let's call him Jack, insisted to Pete that I was not needed to help them raise capital or join GPs at all, but Pete was adamant to bring me in. Frankly, I was flattered by Pete's attention attributing it to his foresight of my financial background. When Pete flew into NYC to meet with potential investors, he invited me to the meeting with them and his realtor. I live relatively close to New York City and I was glad to join in and meet everyone in person. Both: he and his realtor seemed to be terrific individuals, and I was beyond ecstatic about my new adventure.

Our partnership was comprised of three General Partners, three loan guarantors (aka Key Principals) and a bit over twenty Limited Partners. The allocations below are modified for privacy purposes.

- Pete held 60% of our partnership.
    - Pete was the majority partner in our syndication in both ownership-wise and decision-wise. Pete's allocation to own a higher percentage of the partnership totally made sense at the time. This majority ownership was allocated to Pete for two reasons – firstly, he found the property and secondly, he was the "boots on ground" operator.
- Jack held 30% of ownership.
- I owned 7% of ownership.
- And bringing up the rear was Bill, one of the loan guarantors, who held 3% of ownership.



Due Diligence, Reference Checks and Contract Review

I conducted due diligence research on Pete and his business by verifying his track record and references. I gathered as much information as possible, and I was impressed by what I saw. Pete was a family man, had done many single-family flips with good ROI, and he was known in his local real estate community. Pete's team included a professional property management organization that he hired to manage this property and a realtor that helped to find this property. Pete's team members seemed to have high confidence in him, as well as in the future success of the syndication. This deal had all the ingredients to make a lot of money for investors.

I executed the following steps to vet the deal:

- I reviewed the project's underwriting materials to determine whether the project in fact had potential, and I checked Pete's professional background to ensure that he represented himself truthfully through his references.
- I researched the local market and found that its population grew significantly due to a number of factors:

  - Lower cost of living
  - Major employers drawn to this major MSA
  - Less expensive workforce than many areas in the United States
- The following steps were taken to vet my prospective partner's references. (Mistake I made was, I only vetted Pete, but I did not vet Jack.)
  - One of Pete's references was his Real Estate Agent, who found the apartment complex, and the second reference was the Property Manager. Both references provided very positive feedback about Pete, his background and described him as a hard-working and savvy operator.
- Contract Review
  - I reviewed the Operating Agreement and the Private Placement Memorandum, and both seemed generally boilerplate. I was a bit concerned with Pete's holding significant authority, but decided that it was the right decision because his local engagement would require quick resolutions to issues.

☜ TIP ☞

You can find more information how to interpret PPMs in my article, "[Interpreting The Private Placement Memorandum](#)" or watch the short video, "[What is a PPM?](#)"

Takeaways – Due Diligence

Here's what I should have done differently or in addition to the due diligence that I conducted before signing the syndication contract.

Financials and Operation

- I minimized the importance of the fact that Pete had never done syndications. I should have asked Pete as to whether he had a coach or a mentor that he could rely on while executing on value-add strategy on this property.
- I did not request Pete's past personal financial statements or tax returns, nor ordered his background or criminal checks.
- I did not perform stress testing of the project to figure out the point we would start losing money. In other words, I didn't determine the breakeven occupancy point for this property.

Lesson Learned

- *Always vet all (or at least as many as possible) of your prospective partners. Dive into your prospective partners' financials, as well as their personal and even criminal backgrounds.*

- *Have several conversations with each of your prospective partners to ensure your interests and goals are aligned and to get a feel whether you can work together.*

- *Just as importantly, make sure that your partners are experienced investors. Syndications require very a specific skillset, and even related experience may not cut it.*

- *Lastly, pay attention to breakeven numbers. In other words, when reviewing an underwriting understand at what point will a potential property break even.*

Reference Checks

- Pete did not disclose that he was going through a divorce, nor that the Real Estate agent that he used as his reference was his new girlfriend.
- The second reference, that my new partner gave me, was our property manager who only lasted for about 2.5 months (this is a spoiler of upcoming surprises).

Lesson Learned

Question whether your partners' references have a motive to bolster up their good points. Ask if any of the references have family, romantic or financial relationships with your prospective partners. There may be an ulterior motive for a glowing reference. In addition, do your best to find other individuals that were involved in previous or currently ongoing deals with your prospective partners. Don't be afraid to cold-call other refences – they may offer invaluable information.

Contract

I didn't pick up on some of the nuances that were written in favor of the partner who held the majority of the investment – Pete. At the time I didn't realize that majority investment doesn't automatically need to translate into majority vote. Pete had total power to make all operating decisions with his majority vote. We should have included a clause in the Operating Agreement to allow all three partners to have equal voting rights, and for at least two of the three partners to be in agreement when making substantial (worth over $500 in relevance to this project size) operating decisions.

❗ *Lesson Learned* ❗

Make sure that the contract gives equal voting rights to all GPs – the contract is there to protect you and your investors. Your vote is one of the best tools to make sure that your project goes according to plan. Speak with a knowledgeable business attorney – this upfront expense may pay off big time in the long run.

The Investment Property and our Investment Strategy

The property consisted of four buildings with 54 apartment units located in a smaller sub-market within 30 minutes of driving to a major MSA (Metropolitan Statistical Area), which was a huge plus. (Again, some of the numbers are slightly modified for privacy reasons.) The property was in a decent condition and needed some improvements, which mainly included rehabbing all the units.

The investment strategy included renovating at least 70% of all units, and then selling the property in about five years. This was a pretty standard value-add strategy.

☜ *TIP* ☞

These short videos will help you understand various investment strategies, including the one we were implementing called "value-add "– What are the Four Real Estate Investment Strategies? *and* What is a Value-Add Strategy?.

Property Operations, Management and Bookkeeping

Initial Property Operations and Apartment Rehabilitation

The project started off well. Once we closed, Pete immediately bought construction materials to renovate the units and brought in a crew to work on renovations. After renovations of the first set of units were done and Pete shared the pictures, I was ecstatic of how great they looked. But that excitement soon changed into unpleasant surprises and increasing suspicions. About two and a half months into owning the property, without notifying Jack or me upfront, Pete “fired” the PM (property manager).

⚠ Caution ⚠

Keeping information from partners is one example of a red flag. Watch for drastic changes and for trends in operations that don’t quite make sense.

So, by now Pete, who as I mentioned above was also a contractor, was also paying himself for managing the property. The issue with this type of arrangement was that the PM-Pete wrote checks to the Contractor-Pete. Pete’s expenses for construction materials seemed excessive, and every time I questioned costs, he shrugged off my concerns by saying that it’s all part of normal property rehab expenses. But my hunch had proven to be correct – Pete’s approach turned out to be an actual risk to our investment. When about a year into the purchase the bank loan officer, who approved Pete’s fund requests for renovation draws, also realized that they were too excessive for our small apartment complex, the bank froze capital draws and requested detailed financials.

Herein laid another problem – Pete did not keep detailed ledgers. Since Pete could not produce valid financials, the bank eventually issued a default order and advised the loan guarantors that if the property would not produce income in a certain amount of time, it will be repossessed by the bank. Since my name was not on the loan, I was not made aware of this situation, and neither Pete, nor Jack made me aware of this dire change of events until several months later.

Lesson Learned

Make sure that your partners understand that they have an obligation to share critical information with all General Partners. So always ask all your partners to over-communicate rather than under-communicate.

Then after several more months passed by all of a sudden Pete emailed Jack and me that he had enough of self-managing the property and that he had hired a different PM company. This company seemed capable, but nevertheless it did not have commercial asset management experience. Up until this point it was exclusively a residential property management company. And yet again, Pete only shared this decision after the fact.

Operations

When the first PM was fired by my ex-partner without ever advising me or Jack, I was shocked, but I had zero contractual leverage to participate in the decision-making. Jack was very hands off, and he trusted Pete to do the right thing even after I brought up to his attention repeated red flags. Jack made an obvious effort to ignore and belittle my recommendations.

❗*Lesson Learned*❗

- *Again, contracts are drawn for a very important reason – to protect the interests of each partner, so make sure that your contract is not obviously weighed towards any one partner's favor.*

- *It is also extremely important to build earned trust and alliances with every partner prior to entering into a partnership. If you and your potential partners are not aligned on some major issues/aspects of the business, then don't go into business with them.*

Bookkeeping

When Pete said he would self-manage the property, I didn't like the idea, but it seemed doable since he was already our "boots-on-the-ground". However, the next shocking surprise came when Pete also said that we don't need a bookkeeper.

⚠ Caution ⚠

Doing away with a bookkeeper extremely worried me because in a syndicated deal, LPs expect that various tasks should be performed by qualified experts.

Pete asked me to manage the books and when I rejected since I was not qualified to do it, Pete said that he would do that task himself. I was horrified of the consequences, and I tried for months to change Pete's mind. I called Jack, but every single time I brought up my concerns, he just shrugged them off and retorted that our boots-on-the-ground partner knew what he was doing.

It took over half a year to convince Pete and Jack to hire a bookkeeper, and the only reason they agreed was because I was able to find a super low quote. I was desperate, and after querying my network, someone had suggested an offshore team. However, even that decision turned out to backfire. After we used this offshore bookkeeping service for a few months, we all realized that our books were not getting cleaner, but quite the opposite – they were getting messier.

Lesson Learned

- *For any professional services you will need, always go by trusted recommendations, and even more importantly don't hire the lowest priced professional.*
- *Make sure that the professional is not merely qualified to perform their services with expertise but is also familiar with your specific industry.*

The Rude Awakening

As my worries piled up, the original PM called me out of the blue to give me his side of the story. He didn't want anything in return for this information; he was just worried that he was wrongly blamed and wanted to set the record straight. The PM told me that his company thoroughly researched each potential rental applicant. When a potential tenant didn't have a stable job or was not meeting the financial standards to afford renting at our property, they were immediately dismissed. However, Pete took it upon himself to reach out to some of the applicants with questionable jobs and low credit scores, and offered to them to rent our units for a higher price no questions asked. Several potential tenants immediately agreed to this arrangement. Our former PM was increasingly concerned about this lax tenant approval process, and this escalated into arguments with Pete. However, since Pete was the owner and made ultimate decisions, he continued to bring in these tenants.

Another problem the PM saw was that some sub-contractors didn't finish the work or didn't do quality work, but still demanded to be paid. Although the PM wanted them to finish and/or fix the trouble spots, Pete approved payments for unfinished work. The PM disagreed with this approach and once again, these situations resulted in disagreements about how Pete conducted business.

Upon learning this information, I arranged a call with Pete and Jack to get Pete's side. As I expected, their stories did not add up. By that time my trust in Pete was low, so I believed the PM more than I believed my own partner. Pete of course said that these potential tenants were good for our investment because they agreed to pay more than others and it would increase our bottom line. It turned out to be a disaster when one of them left us once-renovated apartment in ruin. And in terms of the subcontractors, Pete said that he trusted them to do a professional job. It was obvious that Pete was continuing down the path of bad decisions, and he either couldn't tell a bad decision from a good one or he was too far down the road of "milking" the property for his own benefit.

The problem was that I was stuck with Pete – he was still legally the major partner, and I had no choice but to continue working with him since I had to ensure I was following my fiduciary duties to my investors.

Unsurprisingly only a few short months later, Pete had an argument with the newly hired PM. Yet again the PM called Pete out for issuing several large amount checks for unconfirmed work. When Jack and I found out about these expenses, I hired a local attorney to attempt to right-side the "Pete" situation. The lawyer's first order of business was to contact Pete to require him to hire a proper bookkeeper and a commercial PM. However, even that did not seem to wake up Pete – he just continued down the path of mismanagement.

I turned to Bill, one of our local LP investors. Since Bill was one of the loan guarantors, he also had skin in the game. And above all he was a terrific asset since he was local, so he could keep an eye on our property. Therefore, with Bill's help we immediately opened a new business bank account.

❗*Lesson Learned* ❗

- *Consider your partnerships to be a "business marriage" of sorts. Hence always work with a qualified business counsel to come up with a business "prenup".*

- *Ensure that the Operating Agreement contains as many "what-if" clauses as possible. For example, ensure it covers such events as* *disagreements between partners, decision-making criteria if one of the partners becomes incapacitated or passes away, etc.…*

- *It's also utterly important to keep tabs on all of your partners' strengths and weaknesses, such as having a partner, who is local to the property be the eyes and ears of the remote team.*

- *Having someone local is a huge plus when managing a property. However, being local is not the same as being loyal to your partners and investors. So always ensure you know your potential partner well enough prior to partnering.*

Wrangling Control from the Main GP

By this time, almost a year into this partnership, I lost count of sleepless nights. I continuously recounted the multitude of issues facing our what I initially thought would be a simple value add investment. Moreover, this investment was a drain on my time, which I should have been spending on other investments. I knew that I had just about reached the point of no return, and that if I didn't take drastic actions, my investors' money would be lost.

I interviewed several more prominent local business attorneys, and finally (through a recommendation) found a practice that had extensive relevant experience handling business situations similar to the one I was facing. Just as my new attorney's legal proceedings kicked in to gear to wrangle away Pete's control, Jack told me that our bank had sent more threatening letters to all loan guarantors. So, these new legal actions were well timed; had I waited any longer, the entire investment would have been lost.

This was where we began the road to recovery, both with the property and with the bank. The light at the end of the tunnel finally appeared when after a few months and thousands of dollars in legal fees, the boots-on-the-ground partner was contractually "fired". He was removed as a GP, and relegated to only remain as a LP.

Investment Recovery

We also finally hired a legitimate bookkeeper service to clean up the mess created by Pete and by the offshore bookkeeping team. The damage was so significant that the new team needed nearly six months to resolve it. When we finally had clean books, I took the responsibility of reviewing every single transaction our current PM was making. I wasn't about to let this hard-won victory slip through my fingers, so I worked my A** off to make sure the property expenses were under tight control. Our PM was very cooperative, and he readily explained when certain expenses seemed to cost more than expected, and in a few cases our account was even credited back.

However, after working with this residential PM for almost eight months, our partner team came to a decision that we needed to replace him with a commercial PM that I chose. Just to reiterate that I mentioned earlier that this PM's specialty was residential properties, and we needed to ramp up our winning streak by hiring an experienced commercial property PM. I conducted several interviews and selected a local experienced commercial PM company. This new company even saved us a bit on off our monthly expenses. I continued monitoring the rehabilitation expenses.

Lesson Learned

The GP's job is to minimize operational expenses, while increasing the property's value. You may need to replace one of your contractors when you realize that they are over-charging you, whether it's deliberate or due to inexperience. Likewise, find ways to increase your bottom line, such as reselling leftover building materials or emptying storage units in the buildings and offering them for additional rent to your tenants.

Always Double Check the Numbers!

While managing the property and working with the PMs, I carefully reviewed every single number and it was no surprise that I happen to find a few mistakes, such as duplicated bills and overcharges. This attention to detail allowed me to return some cash to our project. I also continued to audit the financials and noticed that at one point we had an unusually high electric charge on one of the utility bills. In fact, it was over $1,200 higher – that's about three times the usual amount. When I inquired about this with the PM, he told me that they had already spoken with the utility provider, who advised that the charge was correct. I decided to call the utility company and the representative could not figure out the reason for this higher charge. After some additional investigation the utility company ended up crediting our account $900.

Lesson Learned

Trust but verify! Do not accept hearsay as fact – if something feels wrong, then speak to the source.

Exit Strategy

We've managed to not only hold on to our investment for two more years, but we vastly improved it. And the property was performing increasingly better every month. However, after almost two years wasted by Pete, we were still facing a significant dent on the overall finances.

On top of that issue, the bank was still threatening to take over our property since our Debt Service Coverage Ratio (DSCR or DCR) was barely at 1.00 while it is supposed to be at least 1.25. Since we had expenses that dragged down the DSCR to about 1.00, the bank was not happy. Even though the property had improved, it was just a matter of time before the bank would call in the repayment of its loan. That would be a disaster since we just did not have that much money.

☜ TIP ☞

Debt Service Coverage Ratio is a measure of how much more income than a loan your property is producing. In other words, when your DSCR is 1.00, it entails you're barely making enough income to cover the loan. Watch this video, What is the Debt Service Coverage Ratio (DSCR)? to learn more about DSCR.

After remotely managing the property and bringing it to a balanced state, our partner team unanimously decided that it was time to put it up on the market.

❗ Lesson Learned ❗

Know when to pull the plug to recover as much value as possible. As the proverb says, "Don't throw good money after bad".

Selecting a Broker

While choosing a broker to sell our property, I interviewed three local brokers and Jack interviewed a national broker agency. One of the local brokers stood out and I was promoting this agency as the best choice. Even though his agency was local, I felt it had the ability to present our property in the best light possible. Plus, the agency representative was very pleasant and easy to deal with.

Nonetheless, Jack convinced me (my mistake for agreeing to this) that hiring an out of state broker agency with a national database is the best choice for us.

⚠Caution ⚠

Although our property was under contract twice, both times the sale fell through. This was sufficient proof that we selected the wrong broker.

We were getting desperate, and when the second offer came in, we were even willing to lose about 20% of the total principal just to sell the apartment complex. We lost nearly seven months trying to sell the property through this national agency. I finally insisted that we needed to hire a the broker that best understands the local market. We parted ways with the national agency, and I called back the local broker. We couldn't have wished for better results.

Local was definitely the way to go! In only about three weeks our new broker brought us multiple offers. To be exact, we received 13 different bids on our property.

Lesson Learned

- *Always select the local agency that has the highest number of sales and the local market expertise.*
- *It also helps if the agency has been around for a while. That shows perseverance throughout economic cycles.*

Negotiating Offers

Our ugly duckling project suddenly turned into a beautiful swan. Since our property became so desirable, I took it upon myself to get the highest possible offer for it. Eventually we narrowed our focus to three potential buyer-candidates and let them submit their "best and final" bids, which turned into multiple "best and final" bids until it became obvious that our property could no longer fetch a higher price. This bidding war allowed us to go from a losing project to a profitable one. I was beyond ecstatic. The closing date was another five or so months away, and I continued to manage the property, but the result was absolutely amazing. Considering that we turned around our project from a loser to a profitable investment – that was a godsend.

Lesson Learned

1) *When you have multiple offers, always put them down on the board and create a comparison chart to see all potential pros and cons of selecting one potential buyer over another.*

2) *It is not always about the price, there are other important factors such as how fast a potential buyer can close, do they need financing or paying all cash, how much experience they have with this type of property to close on the deal, how determined they are about moving forward with their offer and etc.*

Management Fees and Reimbursement

Typically, general partners in a syndication charge a set of fees for the work performed such as acquisition, asset management, and then disposition fees.

☜ *TIP* ☞

This short educational video – What are Syndication Fees? – will bring you up to speed about fees that apply to real estate syndications.

To give some credit to Jack, he agreed with me on not taking any asset management or disposition fees or any splits for this project as General Partners. We only reimbursed ourselves for the loans we made to the project, as well as for the legal expenses when we removed Pete as the General Partner. Otherwise, all work was done free of charge to prove our good faith.

Lesson Learned

1) *Make sure that you have a full alignment with your partners and review potential risks ahead of time to come up with potential risk mitigation strategies.*

2) *Make sure that you take care of your investors. Building a reputation is extremely difficult, and you can lose it fast.*

Final Take-Away

SAMO Financial LLC along with our investors has since invested tens of millions of dollars across dozens of commercial real estate projects, and each one has produced considerable profits. The economy had worked in our favor and our investors enjoy the prosperity of the passive cash flow. Even with the recent economic downturn and inflation, we continue to review various asset classes, deals and operators. We predicted this shift in the economy and we are confident that our portfolio is well positioned to weather this storm.

Call To Action

Do your research, make decisions that are best suited for your family's situation, and make sure that you get professional advice – consult your tax, legal and accounting advisors before making any investment decisions.

I am glad to have been able to share this case study with you. It is offered for informational and educational purposes only, and it is not intended as investment advice. If you have further questions, please email us at info@SAMOFinancial.com or use this scheduling link to set up a call to see if we can help you achieve your financial goals.