JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

1. Risk Management/Investment Related Topics

r. "Notes on the Organization & Investment Attributes of Limited Partnerships", no date

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Notes on the Organization & Investment Attributes of Limited Partnerships

I. The limited partnership has undergone a variety of transformation of real estate investment area.

A. It is used at the local level for small groups of passive investors providing capital for land banking, investment clubs, and group investment packaged by a local real estate broker.

B. For a time a number of specialists packaged partnerships, often combining securities in a French plan. When a well known syndication plan called SIRE faltered because it was unable to pool its cash resources legally to save a motel project, a number of other operations such as that of Marvin Kratter converted to public corporations and lost their exclusive real estate orientation. Indeed Kratter Corporation went into the business of sports franchises, ship building, etc.

C. By 1959 the idea of large scale limited partnership operations was thought to be unwieldy and the real estate investment trust act was expected to provide corporate characteristics for a tax conduit for the small investor. However, the IRS required that the trust be passive and that losses could not pass through to the investor so that it is an imperfect conduit and cuts off the investor from participation in the creative aspects of real investment.

D. As the tax shelter became popularized and mortgage money became tight or too expensive developers saw a way to finance equity requirements by use of the limited partnership. Popularity was underscored by the 1969 tax reform act, FHA program, and the poor performance and bad press given the stock market, mutual funds, and in some cases cattle and oil tax shelter devices.

E. In the last five years a new breed of real estate financier has appeared - a packager of real estate syndicates. These packagers have a number of motivations:

1. To create a market for a property in which they have other profit centers such as construction, land, or mortgage financing but for which they don't want to own it.
2. For a company with expertise and rapid expansion of branches, syndication has many advantages over franchising or simple internal financing because they can obtain 100% financing, retain control as a general partner, and receive profits according to a distribution schedule with incentive kickers.
3. A syndication has interesting applications for funding high risk business interests with a lower break-even point as interest on the money invested is contingent on earnings while even losses in the early years are attractive to certain types of investors.
4. For the commissions and profits involved in buying wholesale and selling retail as there are a variety of profit cuts which can be taken.

F. Packaging involves very complex process for both the promoter and the investor. There are two basic forms of syndication. In one the property or properties are specified from the outset while in the other the actual property are unspecified - often termed a blind pool syndication and it is of growing popularity.

1. For the specified asset syndication, the promoter first finds a desirable property to control with an option or conditional purpose while he goes through a period of securing regulatory approval and raising investor money. An unpredictable and prolonged process at best, seller demand a higher price than they would receive with a quick closing.
2. The blind pool fund reverses the timing problem by first raising the money and then seeking the property, presumably providing more efficient acquisition. Critics maintain that cost savings are not as cheap because fund managers are under pressure to show immediate results and therefore cannot play a waiting game or be too discriminating since the care with which they structure a deal won't make or break it for the investor.

G. The many activities of the packager would include:

1. Extensive search and analysis of alternatives
2. Negotiating for control and purchase option
3. Structuring investment for financing including second mortgages and leasebacks, careful arrangement of tax implications, particularly for front end deductibility and determination of indirect cost of syndication.
4. Preparation of a detailed prospectus for full disclosure
5. Securing of regulatory approvals, including:
   a. Securities and Exhange Commission
   b. State blue sky agencies
   c. Clearance for prospectus and advertising with Nationsl Association of Security Dealers
   d. IRS for tax opinion
6. Planning and execution for a promotional campaign
7. Proper training of security sales force
8. Selling the interest to investors
9. Implementing a control system for investor funds, documents, escrow funds, etc.

II. There are an infinite number of syndication terms and features with which the investor must be familiar and a few of the problem areas are suggested below:

A. Although many limited partnership involve a one time commitment of funds, some involve contributions in two or more time periods. This is particularly true to develop or refurbish a new property who wishes to correlate in investment to the availability of tax deductions as well as to the need for cash and the availability of distributable income.

B. A partnership agreement should address the problem of assessment for additional contribution as this represents a serious chink in the presumed armor of limited liability. Agreements may contain:

1. A stipulation of mandatory assessments to provide additional funds for unexpected negative cash flow. These provisions provide penalties for those partners unwilling or unable to make additional contributions if called upon to do so. These may reduce proportionate ownership or deny opportunities to participate in future cash flows until payback of assessment is complete. There may also be a ceiling for the assessment for any one year or on accumulative basis.
2. A stipulation of no assessments
3. A provision that partners may loan funds to the partnership, either the general or the limited partnership
4. A provision for sale of additional limited partnership shares with original partners having right of first ~~first~~ refusal.

C. The compensation to the syndicator is of three kinds:

1. Money at the front end as reimbursement for specific costs, as a flat commission for money raised, or as a percentage on assets acquired.
2. Fees for managing the property
3. Participation in the venture
4. The most popular fee is the real estate brokerage commission, acquisition fee, or management fee as a percent of assets acquired. ~~and~~ This may be a sleeper as it may be paid to a brokerage subsidiary of the syndicator by the seller. There can be terrible potential conflicts of interest and since the syndicator performs a different function than a broker it seems his compensation should be on a different basis. Obviously the syndicator is interested in selling a property on which he has a listing and a commission and not the property best suited for the investors.
5. The preferred form of front end compensation is a straight forward fee and a percentage of money raised. Given the expenses of syndication it is difficult for a syndicator to make money on a small volume basis without taking excessive front end fees or unless he has other profit centers in the project. An underwriting commission can contain an override on commission paid dealers.
6. Real estate is highly leveraged on a deal with a 75% loan a 6% commission will represent 25% of the equity raised or 60% on an FHA deal with an FHA loan as opposed to an underwriting commission of 10% on the equity raised.
7. The management fee is often payable to the general partner who is also the syndicator. There are substantial expenditures for services and often the general partner will provide these for additional compensation including insurance, furniture and appliance rental, and maintenance labor.

8. Syndicators can give themselves a promotional interest in a variety of forms. They could receive a straight percentage interest with equal status to the investor, such as capitalizing at $100,000, selling $80,000 and keeping 20% of all future receipts. Another form would be the right to a certain percentage of cash distribution or a subordinated interest with investors receiving a certain minimum first.
9. Some syndicators use a wrap-around mortgage or all inclusive trust deed. In short the syndication pays the syndicator an interest and principal payment while the syndicator in turn pays an underlying mortgage which generally has a lower interest rate and shorter amortization. The spread between interest rates and the difference in the balance amortized by the syndication provide a profit spread for the syndicator.
10. The syndicator can sell it to investors or his option for more than he paid for it. Some syndicators argue the markup won't change cash throwoff and will actually increase tax depreciation. For example, a million dollar building with a cash throwoff of $110,000 could be sold for $1,100,000 and still show a 10% return. If the improvements were eligible for 200% declining balance 25 year depreciation, the extra $100,000 would actually produce an additional $8,000 in tax shelter depreciation.
11. Syndications often involve a leaseback of the property to the syndicator. For a new rental property this represents a rent guarantee whereby the syndicator is providing a certain minimum cash flow over a period of time. On an established building a leaseback gives the syndicator the opportunity to keep the increase in net income over and above the lease terms.

D. The promoters participation interest provides an infinite variety of opportunities for profit or variance control, either for the developer or the investor. Participation interests for the general partner involve precise definitions of such things as his return, investment, and proceeds from the sale as well questions of priority, cumulative features and pretax or aftertax viewpoints. The number of opportunities for skimming this presents are endless but properly structured they represent incentives of the general partner which are to the best interests of the limited partner.
   1. Refer to worksheet of definition of return, sales proceeds, refinancing or investment
   2. At the very least the general partners patticipation should be subordinate to the limited partners on no less than one of the following:
      a. A specified return on their investment
      b. A return of their investment
      c. A specified return on their investment plus return of the investment
   3. There are two variations on how the general partners subordinated participation is calculated. The net method uses the balance remaining after the limited partners have received their preferential return as the base. The gross method uses the total return and is adjusted for any claim in excess of proceeds. For example, consider a cash distribution of $100 with where the general partner receives 10% of net or gross after subordinated

partners have received 6% on their $1000 investment. The net method would be:

$$X = G[D - (R)(I)]$$
$$X = .10\ [100 - (.06)(1000)]$$
$$X = .10\ [100 - .60]$$
$$X = .10\ [40]$$
$$X = 4$$

If the gross method was:

$$X = (G)(D) \text{ if } [D - (R)(I)] \geqslant X$$
$$X = (.10)(100) \text{ if } [100 - (.06)(1000)] \geqslant X$$
$$X = 10 \text{ if } [100 - 60] \geqslant 10$$

Notice the substantial impact of a subtle shift in terminology in the prospectus.

4. Similarly consider how the priority of the return to the limited partner is defined will have a significant impact. Assuming the following:

   I = $1000, the initial investment
   P = $1300, the sales price
   C = $200, cumulative return distributed to limited partners
   T = 5, investment period in years
   R = 6%, the specified annual rate of return to the limited partners

   Specified return on:

$$X = P - [T(R \times I) - C]$$
$$X = 1300 - [5(.06 \times 1000) - 200]$$
$$X = 1300 - [300 - 200]$$
$$X = 1200$$

   Specified return of:

$$X = P + C - I$$
$$X = 1300 + 200 - 1000$$
$$X = 500$$

   Specified return on and of:

$$X = [P - I] - [T(R \times I) - C]$$
$$X = [1300 - 1000] - 5(.06 \times 1000) - 200]$$
$$X = 300 - 300 + 200$$
$$X = 200$$

5. Up to now we have not considered the implication of the general partners participation on a limited partners tax position. Taxes complicate the problem.

E. If distributions to the general partner were classified by the IRS as expenses they would reduce the net taxable income or increase the net taxable loss or tax shelter. Since the tax shelter is a prime advantage of the partnership investment this is significant.

On the other hand in the American tradition those who take no risk of loss should take little share in the profit. Thus it is significant as to whether the general partner participates in a percentage of net profit or in net taxable income as the former excludes losses.

1. The issue is whether the general partner is considered an outside party or an equity position as regards the partnership. A subordinated interest is not a credit obligation and therefore an expense. However, if it were carefully designed and named as an incentive management fee, a strong case could be made for classifying such a payment as a deductible expense so that it would increase and not dilute limited partners tax shelter.
2. The typical limited partnership subordinates the general partner to a prefered return on a before tax basis which could leave the limited partners with less cash than was required to pay taxes where tax shelter was declining. The formula for returns may need to assume an arbitrary income tax factor (such as 50%) in order to eliminate a general partner share in non-sheltered cash.
3. If the general partner participates in the net he receives ~~in~~ a return only on the last marginal dollars. For example consider a cash flow of $70 with the general partner to receive 10% subordinated to a 6% return or $60 to the limited partner. If the general partner receives on a gross basis he will get $7 but on a net basis he receives $1. If he is sharing in the net tax loss, it is clear that the general partner receives something only because of the accelerated depreciation. It could be argued that if the general partner receives disproportionate benefits from the use of accelerated depreciation, he should bear a disproportionate burden of the ordinary income tax on recapture. The general partner is probably a dealer and is indifferent to taxation of his proceeds as recapture of excess depreciation.
4. Upon liquidation and sale a fee to the general partner will reduce the gain to the limited partner thus reducing the capital gains tax. Thus the actual cost of paying the general partner is less than a full dollar because of the tax effect.
5. Other tax questions could involve sale proceeds which could include prepaid expenses or prepaid interest and such a refund is a taxable event. Should the general partner pay taxes on these funds if he did not benefit from the original deductions? These problems suggest the necessity of explicit definition of how the tax shelter and cash flow proceeds will be divided and the care that is necessary in determining the base to which percentage participation are applied. In highly leveraged real estate a small amount of variance in forecast has a tremendous marginal effect on benefits. Moreover, marginal revenue and marginal costs are extremely sensitive to management ability so that incentive systems for the general partner are of critical importance. Moreover participation interest is becoming more prevelant as regulators crack down on front load compensation.

III. The marketing of limited partnerships has become a complex process. Regulators are spawning new hurdles daily, effective channels of distribution are lacking, and the complexity of the investment and lack of public sophistication requires tremendous education of both the sales force and the customer. A real estate limited partnership interest is a security fine tuned to the federal tax and dependent on the highly selective characteristics of real estate assets - a potnetial bummer if there ever was one. Syndication interests can be marketed by direct selling in the traditional real estate manner, by the seminar approach, or through channels as a security.

A. The traditional approach involves a salesman prospecting and then working directly with the client which includes visits to the syndicators office, special presentations, inspections of the property, and so on. Essentially the same process is followed as if one were selling the building instead of $5000 or $1000 of shares. The amount of money raised per prospect does not justify time and expense required.

B. Since the selling process involves considerable preliminary education the seminar approach seemed a logical solution. The syndicator advertises a seminar or teaches an adult education program, serves refreshments and establishes credibility with a panel of experts. The costs of the whole show are extensive and you may be treating your competitors as well as the curious to an education and the syndicator may not be very effective at recognizing serious prospects.

1. In April of 1971 the federal court in California enjoined the Firestone Group from holding seminars as they precondition investors to purchase future unregistered securities. A syndicator was distinguished from an investment banking house on the basis on the number of offerings which it had. A regular investment banker offers a wide variety of investment alternatives even though using seminars to condition his prospects while the securities exchange commission felt the syndicator was improperly gaining credibility for a single project in which he was both salesman and prime contractor and thus biased.

C. Given the SEC position against educational seminars and the falloff in credibility for seminars, the third approach treats securities in the same way that mutual shares are fund marketed. It features mailing of a prospectus, plus certain promotional material plus telephone solicitation. A Wall Street brokerage firm thus enjoys the significant edge over a syndicator who must establish his own sales force and public image.

1. A basic marketing problem is the fact that security salesman may either be affiliated with NASD member brokers-dealers or with real estate brokers but not with both as NASD regulations prohibit members from participating in non-security offerings. Thus the wire houses have a competitive edge and an appetite whetted by their involvement with investment trusts.

D. Advertising for partnership securities involves one of several philosophies:

1. A specific investor offering through a tombstone ad
2. A specific offering with an ad carrying a summary of information from the prospectus
3. A general educational piece on benefits of syndicate shares and the professional ability of the syndicator. Often the approach is to "reveal" tricky pitfalls in order to establish credibility and frightening the flock into your corral. ~~(pages 80 & 81) (and page 71)~~

IV. Syndication financing strategies are expanding from the one property one interest pattern of earlier years. Innovations occur daily and revolve around problems of divisibility of profit centers, time line, and variance control by means of guarantees and incentives.

A. Among the important considerations concerning the details and strategy are the following:

1. Should the portfolio consist of a single or multiple properties?
2. Should the properties to be owned by the partnership be specified or not specified?
3. Should the partnership terminate with the sale of its original assets or should there be provisions for the acquisition of additional properties?
4. What provisions should be made for liquidity?
5. Should there be one classification of partnership interest or multiple classifications of partnership interests, each serving specialized objectives?
6. Use of guaranties, earn outs, leasebacks for control of variance of projected return
7. Open or closed end registration.

B. Incentive arrangements have included such things as :

1. Developers profit via an earnout which is voided if rents do not realize a certain level in 36 months.
2. A guarantee by the developer against negative cash flows during the first 42 months of the project.
3. A management fee of 5% subject to a downward adjustment at the end of periodic intervals if certain expenses have increased at a greater rate than gross rental income.
4. The permanent mortgage is a balloon mortgage in 20 years at 9% interest and 10% constant and is not prepayable for 15 years. Lender participates in 15% of the increase in gross over a minimum.
5. To protect against construction of a competitive unit on a adjacent property the partnership has an option for 36 months to purchase the adjacent property if its improved with a residential apartment building and after that time the option becomes a right of first refusal on any sale by the developer prior to 1980