Actively Passive

Commercial Real Estate Terms

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506(b) and 506(c)

Operating under Regulation D, Rule 506(b) and Rule 506(c) regulations (actually exemptions) are the most common syndication methods used by multifamily syndicators. Sponsors using 506(b) can accept both sophisticated and accredited investors, while 506(c) can only accept accredited investors. Sponsors usually have a preference for one or the other going forward into future projects, and must list the number of each type of investor with their SEC filings. Within these are certain restrictions affecting the kind of investors they can accept.

Accredited Investor

A person who meets certain net worth, income, or knowledge requirements.

Agency Loan

This is a long-term mortgage through Fannie Mae or Freddie Mac, secured by an income-producing property.

Alignment of Interest

This means that the goals of the syndicator are aligned with the investor and promotes the feeling that each is part of a team working toward the same ends, not working against each other. It ensures that conflicts of interests are minimized.

Apartment Complex/Community

Generally, anything larger than a quadplex is considered multifamily commercial real estate. Apartment complexes can be composed of several buildings inside of which there are several homes. While the minimum size of a multifamily property is 5, there is no maximum that I know of, and can consist of hundreds or even thousands of homes. These are usually owned and operated by a single entity to produce cash flow by charging for rents and other services.

Average Annual Return (AAR)

This is the average annual return an investment produces. Not to be confused with return on investment, in this context, AAR includes the return of investment plus any profit in the form of cash the project generates as well as the appreciation, and is divided by the number of years the project is held. It is expressed as a percentage, and doesn't take into account any effects of compounding.

In its simplest terms, AAR measures the money made or lost by a real estate investment over a given period of time. You will want to consider the AAR when looking at syndication opportunities and compare it with others. This allows for the comparison of projects that have different time horizons. Say for an example that projected returns on a $100K investment will be $100K over 10 years, giving you $200K at the end. This works out to be a 10% average annual return. Now if you are looking at a similar opportunity that returns the same amount over a 5-year period, you would calculate the AAR to be 20%. I think we would agree that the second opportunity is the better option, all other things considered equal.

Break-Even Occupancy

This is the occupancy percentage needed in order to cover all expenses, including debt service, on a syndication project.

Business Plan

At the heart of every good investment opportunity is the business plan. It outlines the HOW of the way a project will be run and managed. It needs to be pragmatic, detailed and show clear objectives, strategies and tactics, and will provide the pro forma incomes as well as expenses. As most syndicators have a value-add goal in mind, the business plan needs to show how higher quality tenants will be acquired and how vacancies will be reduced, identify improvements to the property along with associated construction costs, and changes in expenses and incomes. They need to logically show why the plan makes sense in the context of the surrounding neighborhood and all the things they intend to achieve.

Capital Expenditures (CapEx)

Funds used to improve and extend the useful life of a property through upgrades and maintenance. It usually includes interior and exterior expenses such as flooring, roofing, appliances, lighting, some types of landscaping, heating and cooling units, new buildings and siding.

Capitalization (Cap) Rate

The cap rate Is an important metric used to determine a property's value as compared to similar properties. Generally, the prevailing cap rate of an area works similarly to the comps used in single-family housing. Using this prevailing cap rate and calculating it with the NOI gives you a property's value as compared to comparable properties. In a way, the cap rate can be thought of as a comp. Another way to look at it is the yield of an investment over a 1-year time horizon with an all cash purchase. It tells you how much you would make on an investment if you paid only cash for it (no financing), and is the NOI divided by the purchase price.

Cash Call

This is cash required from investors after a project has begun. Typically, if a cash call is made mid-project, chances are that there were some unforeseen expenses or some other calamity that reduced the operating account to a point that the project is in trouble.

Cash Flow

Revenue left over to distribute after all expenses and debt service have been paid.

Cash-on-Cash Return (CoC)

The CoC return (and sometimes indicated as CCR), for an investment measures the amount of cash flow a project will generate as a percentage of the total invested cash. This can also be referred to as the equity dividend rate, and you can almost view this like the interest rate on a savings account. This capital gain is expressed as a percentage and can be used to compare the projected returns that a real estate syndication investment might offer, and is an average annual rate for the length of that project. By the way, though this term is most commonly used in the context of real estate, it can apply to other investments as well. The equivalent in stocks would be noted as the return on investment, or ROI, except that in this case the CoC does not include any of the profits of a sale.

CoC = annual net operating income (NOI) divided by the total cash invested.

Class A, B, C, D Property

When we talk about the ABCs of real estate, we are really defining the property classes of the assets, or describing the characteristics of a potential real estate investment. The Classes are A, B, and C, and help classify a property based on geographic area, physical condition, and tenant and surrounding demographic characteristics. Each class implies different levels of risk, reward, challenge and value. When reviewing syndication offerings, these are often referred to as class A, class B, class C and even class D.

Concessions

These are usually bonuses and enticements meant to persuade a tenant to sign a rental agreement. These include things like a free month of rent, a gift card for signing, and application fee waivers. There is often a cost associated with concessions which you will find on the T-12.

Core Property

This could be considered an institutional quality asset in a major core market such as a class A property that has been fully stabilized and leased for years. It will most often be in a highly desirable or upscale part of town and offer many amenities. These properties usually command the highest rents and the most credit-worthy tenants, so are considered the least risky investment.

Core-Plus Property

This is very similar to the core project, but with a little bit more to it, even though this type of project tends to be high-quality and well-occupied. The property might still be sort of new (under 15-years old) but needs some very light property improvements, cosmetic refreshes, or management restructuring, which will create the ability to increase cash flow. There might be a little less predictability than the core deal, but a lot more predictable than the value-add investment project. In fact, think of core-plus as a core project with a slight value-add component.

Corporate Housing

Specialty type of multifamily real estate. These are often fully furnished apartment-style rentals that are rented for shorter periods, like 1-3 months, to companies that need to temporarily staff up in different geographic areas with employees that live outside the area.

Cost Segregation Study

This is a study that reclassifies building costs to permit a shorter, accelerated method of depreciation for certain building costs. The primary goal of a cost segregation study is to categorize all construction-related costs that can be depreciated over a shorter tax life, typically 5 to 15 years, than the building, which is 27.5 years for residential real property.

Crowdfunding

This is a method for raising funds and is commonly used by syndicators, and is typically managed or operated through an online platform, enabling you to own property and earn profits with minimal effort. You can browse through the opportunities on a marketplace website and choose an investment that matches your needs. The platform also gives you the ability to track the performance of your investment and see the passive income it generates.

Many other investors will be doing the same, allowing for the syndicator to pool the funds necessary for a project to begin.

Some syndicators who might have a very lucrative deal just do not themselves have a huge number of investors to offer to, so crowdfunding exposes them to many investors that they may not have had access to previously.

Debt Service

These are the loan payments to a lender in the form of interest and principal in order to keep a mortgage current.

Debt Service Coverage Ratio (DSCR)

This is a ratio of cash flow available to service a debt against the amount of debt payment in any given billing cycle. This number is calculated by dividing the NOI by the minimum debt payment. Most lenders will not lend if this number is less than 1.25.

Depreciation

This accounting expense is rooted in the truth that since assets tend to wear out over time, we account for that reduction in value, deducting the cost of an asset over its useful life. In most cases, this works out to be a way to defer paying taxes until a later date. This is because although part of a property's value has been written off due to wear and tear, the sale of the property usually ignores the depreciation and sells for the full price as though there has been no decline in its useful value. Despite this, using depreciation is a good way to shield some of a syndication's profits during the first few years against most taxes. Depreciation is a method of delaying the payment of taxes.

Distribution

This is the cash paid to you by the syndicator on a periodic basis. The amount distributed will likely vary each time and will be directly affected by the amount of money there is available to distribute, as well as if there is a preferred return, or how any profits are supposed to be split. It is not uncommon for distribution in the first year of a syndication to be minimal or nonexistent. This is usually the time period where the value-add business plan is being executed, and there is a lot of capital expenditures.

Doors

Another term for units of an apartment building.

Due Diligence

This is the phase of a project, before acquisition, where a syndicator is scrutinizing the property data and pouring over every number possible. Audits and inspections are part of this process.

Duplex

This is a building that is composed of two homes within one building.

Equity Investment

This is the amount paid by investors at the beginning of a syndication for ownership in a project. It will usually be used to make a down payment, pay closing costs and fees, funding an operating account, and sometimes be used for capital expenditures and renovations.

Exit Cap Rate

The cap rate at the time of sale or disposition of a property.

Exit Valuation

The value of a syndication property when it gets sold.

Fees

Fees come in the form of asset management fees (usually 1%-3%), acquisition fees (likely 1.5%), loan guarantee fees, and disposition fees.

Forced Appreciation

Forced appreciation is a term used in commercial real estate that means improving a property in order to increase its value. This is the opposite of market appreciation, which is the natural or organic increase that happens over time or due to local growth. A multifamily property gets its value from the calculation of net operating expenses divided by the prevailing cap rate of an area, neighborhood or property. Therefore, as an apartment syndication's income rises (in relation to expenses), the higher it is valued. In some cases, this can be dramatic which makes investing in apartment communities so appealing.

Garden Style

Type of multifamily real estate. A building style usually characterized by one- and two-story, semi-detached buildings, with the entry to each unit on the ground level. The development is typically built in a garden-like setting in a suburban, rural, or urban location, and may or may not have elevators.

General Partner (GP)

In the context of a syndication, a GP is a the person or organization that finds, acquires and manages an income-producing property and has the responsibility to manage that property. Also referred to a syndicator, sponsor, and operator.

Ground-Up Development

A ground-up development project can potentially produce the greatest level return of any multifamily real estate investment strategy because shrewd developers can tap into patterns and trends for demand, and build to suit specific tenant profiles. But on the flipside, these tend to be the riskiest projects because of the high level of complexity and long projected hold periods without cash flow. Most of any profits to be had come in the form of appreciation in value at the time of sale.

Holding Period

The time of a syndication project from beginning (acquisition) to end (sale or disposition). A syndication holding period is typically 3 to 7 years.

Hurdle

A target that might change the split or returns in favor of the syndicator when a project becomes highly profitable. It is meant to align interest and give an incentive for doing exceptionally well.

Income Statement (T-12)

The income statement will usually be in the form of a trailing 12-month (T-12) accounting of all incomes received through rents and other fees, as well as all expenses, utilities, legal fees, admin and marketing costs, and taxes for the 12-month reporting period. In the income section, other than rents, you will see laundry income, pet fee income, application fee income, utilities reimbursements, and other fees that tenants pay the operator. In the expenses section, you will find all costs broken down into categories, and will often list debt service payments. Also known as a profit and loss statement.

Internal Rate of Return (IRR)

IRR accounts for the time value of money. A given return on investment received at any given time is worth more than the same return received at a later time, so the latter would yield a lower IRR than the former, if all other factors are equal. In other words, if the amount returned on an investment is the same, the IRR would get lower as the time it takes to get that return is stretched out.

The percentage rate earned on each dollar invested for each period that it is invested. The internal rate of return (IRR) is a method of calculating a real estate investment's rate of return, or annualized effective compounded return rate. The term internal refers to the fact that the calculation excludes external factors, such as the risk-free rate, inflation, the cost of capital, or financial risk. The IRR is an estimate of a future annual rate of return, and can also measure the actual achieved investment return of an investment. You may also hear the term discounted cash flow rate of return (DCFROR), which is essentially the same.

Job Growth

Job growth goes hand in hand with population growth, and is a powerful driver of your syndication investment returns, because a steady or increasing wave of new jobs is key for the demand of multifamily housing. A healthy labor market is vital to a continuously rising rate of demand for apartments in desirable neighborhoods. Property values grow in areas experiencing growth in jobs, as newly arriving workers compete for the supply of multifamily units and homes, especially near large employers.

Letter of Intent (LOI)

This is a non-binding agreement, initiated by a syndicator to a property seller, indicating interest to purchase a property. This includes an offer to purchase, the dollar amount, and any terms or conditions for that purchase. It is customarily the first step for making an acquisition and is followed by a purchase and sale agreement.

Limited Partner (LP)

In the context of a syndication, a LP is a passive investor and has no responsibility to manage a property. LPs have an equity position in an income-producing property, and can participate in any profits and resulting distributions.

Loan-to-Value Ratio (LTV)

This is the leveraged amount of a purchase and is represented by the loan value divided by the appraised value of a property.

Loss to Lease

This is the difference between actual rents being received compared to the market value (market rent) of those units, and is expressed as the gross potential rent (GPR) minus the current rents.

Luxury

Type of multifamily real estate. Typically a class A property, newer and with many amenities, is an upscale apartment community where average rents are relatively high. They are generally located in highly desirable neighborhoods or business hubs, and tenants are more often white-collar workers and high-quality renters.

Manufactured Housing Community

Type of multifamily real estate. Sometimes referred to as a trailer park or mobile home park, it is a community in which the operator leases ground plots and hookups to manufactured/mobile home owners. The operator might even be leasing a number of these units to residents.

Metropolitan Statistical Area (MSA)

This is the geographic region with its associated demographic statistics.

Midrise

Type of multifamily real estate. Sometimes referred to as a walk-up in the case of a 4-6-story building without an elevator, and a 4-9-story building with an elevator, typically in an urban area.

Mixed-Use Buildings

Type of multifamily real estate. This might include properties that have retail spaces on the street level, with apartment units on the floors above. In some cases, such as the John Hancock Tower in Chicago, these can contain retail stores, offices, gyms, spas, and TV studios, as well as condos and apartments.

Multifamily Property

A type of commercial real estate property that is used specifically for generating rental income. It is a building or complex of buildings that have 5 or more residential units.

Net Operating Income (NOI)

NOI is the annual rental income minus operating expenses, not including debt service. NOI is calculated from rental and other income a multifamily property produces, minus all the expenses and salaries needed to manage a property. This does not include expenses for servicing debt, like mortgage payments. Nor does it include any cash distributions to any general or limited partners (investors).

Offering Memorandum

This is the investor packet you will receive from a syndicator outlining the investment opportunity.

Operating Account

An account normally used for the day-to-day cash needs of a syndication. A healthy operating account has enough money in it to handle any extreme ups and downs without the need of making a cash call.

Operating or Company Agreement

This document contains articles of organization, allocations of profits and losses and distributions, management structure rules and what-ifs, and other general provisions of the managing LLC for a syndication.

Operator

Someone who puts together a syndication, and is responsible for finding the property, raising funds from investors, acquiring the property, managing the day-to-day operations of the project, usually following a 3-7-year business plan.

Opportunistic Property

Think of this as a class C or class D property with a business plan that needs to be on steroids. To realize its potential, this type of project tends to need significant improvements and rehabilitation. Further, the property could be experiencing high vacancies with poor tenant quality at the time of acquisition. This will likely be a much heavier lift than a value-add property, but with higher risk and rewards.

Passive Income/Investing

Income derived from investing in such things as real estate syndications, and having no responsibility for managing the real estate.

Population Growth

A key demographic, population growth is a huge factor affecting multifamily housing demand. When this happens, it indicates a healthy area that will likely support the other demographic measurements. We often see population growth driving income growth, or vice versa. Generally, the greater the growth in population, the greater the demand for apartments, as past population growth rates have shown. Demand is a key driver for rent increases. To support this, as population growth generates pressure on employers to increase salaries – incomes go up faster.

Preferred Return

The term preferred return is a return that puts you, an investor, in a preferred position when it comes to profit distribution of a project's cash flow. Money goes to you first when there is a distribution, and until the hurdle of the preferred return is totally met, the syndicator gets nothing. If a project doesn't make any money, chances are that you will not receive a return. A preferred position is first in line. This preference offers a bit of comfort to investors because it subordinates the sponsor's profits (sometimes called the 'promote') to yours. The profits can come from the operation of a project (rents) and even from the sale or refinance of the property.

Private Placement Memorandum (PPM)

This is a syndication disclosure document that reiterates the risks of investing in a real estate project, spells out things in the syndicators' backgrounds, and restates some of the terms in the Operating Agreement.

Pro Forma

Forward-looking financial projections.

Purchase and Sale Agreement

This is a legally binding contract between a syndicator and a seller for the purchase of a property.

Quadplex

This is a building that is composed of four homes within one building.

Ratio Utility Billing System (RUBS)

This is a system used to reimburse the cost of utilities by the tenants to the operator. The amount is often obtained by calculating usage based on occupancy, and is billed back to the tenant. This income directly affects the NOI and in turn help increase the value of a property.

Real Estate Investment Trust (REIT)

A real estate investment trusts (REIT) can be a corporation, trust, or association that invests in income-producing real estate. One advantage here is that you can invest in real estate without the expense, knowledge and management responsibility needed on buying actual property.

Recapture

When a taxpayer sells an asset for a gain after taking deductions for depreciation, depreciation recapture is used to tax the gain. The tax authorities will always get the taxes owed to them.

Rent Premium

The increase in rent (demand) after a value-add plan has been completed. When you hear the term proven rent premium, this means that the value-add plan was completed on a smaller scale and is the proof-of-concept for the bigger, overall value-add plan

Rent Roll

The rent roll is the current operator's list of income received in the form of rents and fees. It will account for every unit at the property, show the current rent payments received, the lease term, when rents are received for the current month, late fees assessed, and usually the going market rate for each of the units. This is a snapshot in time, and is usually archived on a daily, weekly or monthly basis, and analyzed over time to see trends or to help plan for future activities.

Schedule K-1

As part of an IRS income tax filing, the Schedule K-1 is the annual reporting that you will receive from the sponsor in a multifamily syndication. It is similar in purpose to the Form 1099. The syndication LLC files an information return to report their income, gains, losses, deductions, credits, and the K-1 lists the beneficiary's share of these incomes, deductions, credits. The LLC does not pay tax on its income but "passes through" any profits or losses to its investors, who in turn must include K-1 item info on their tax or information returns. You may be liable for tax on your share of the syndication income, whether or not distributed. Do not attach the K-1 to your personal tax return unless you are specifically required to do so, as the syndicator will have already reported its contents to the IRS. Keep it for your records.

Senior Housing

Specialty type of multifamily real estate. Dedicated to housing senior citizens, these can be facilities that provide different levels of care for independent or even ailing seniors. These often have nursing staffs as well as community activities directors. Depending on the services provided, these are considered senior living or nursing homes. It is predicted that the demand for these types of arrangements will rise dramatically as the population ages.

Sensitivity Analysis

Assuming the project will go exactly as planned is always the wrong assumption. Stuff happens. So, this is the area where you want to start asking what-if questions. One of these areas is a break-even occupancy ratio. This is the number that shows the break-even point for a project to not make money. Anything below this causes a loss. You want this number to be as low as possible in order for increased success with your investment. Often, a good break-even ratio might be 60% occupied. In this case, this means that the syndicator can still make money on a project if they maintain occupancy above 60%.

Short-Term Rental

Specialty type of multifamily real estate. Airbnb comes to mind when classifying this specialty. These take the form of bedrooms or even full properties being rented by the night or the week, and are most often operated like a hotel. This was considered a hot investment category up until the 2020 pandemic.

Sophisticated Investor

Also known as a non-accredited investor, a sophisticated investor must have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment. These non-accredited investors must either possess sufficient financial knowledge on their own or be advised by a purchaser representative who has the necessary sophistication, and should be able to make an informed investment decision without the full disclosure provided in a public offering. A sophisticated investor does not need to meet the financial thresholds in the accredited investor definition to invest in certain offerings, but can only participate in offerings under Rule 506(b).

Split

This applies to the way any profits are divvied up to the general and limited partners. This might look something like a 70/30, 80/20 or even an 85/15 split with the higher number (percentage) going to you, the investor.

Sponsor

Someone who puts together a syndication, and is responsible for finding the property, raising funds from investors, acquiring the property, managing the day-to-day operations of the project, usually following a 3-7-year business plan.

Student Housing

Specialty type of multifamily real estate. Intended for students attending a nearby college or university, these are nowadays rented to students by the bedroom. A unit might consist of a 3- or 4-bedroom, 1- or 2-bathroom apartment, with the students sharing the common areas within, like the kitchen and living room. Many of these arrangements are full service, meaning that the operator provides utilities, weekly cleaning, and other services designed to make the lives of the students easier and assure the parents that their kids are being well taken care of.

Submarket

A smaller more specific are within an MSA.

Subscription Agreement

Usually attached to the PPM, its function is to spell out the number of shares you have in the investment and how you are taking title to those units. It also reaffirms your agreement to the terms listed in the other documents.

Subsidized Housing

Specialty type of multifamily real estate. This type of housing caters to low incomes renters or those with special needs, and is made affordable to income-restricted individuals through local government backing. Residents in these programs get a portion or all of their rent paid by the sponsoring government agency. Section 8 is one of these programs where the property owner is bound by some stringent rules to maintain a certain level of living conditions.

Syndication

Generally speaking, real estate syndication is a vehicle for people to pool their monetary resources, organized by a syndicator or sponsor, in order to invest in properties and projects (in this context I will be discussing multi-family properties) that are much larger than they could manage on their own. In the past, only the wealthiest among us were able to participate, but with new legislation over the past decade, this has become more accessible to investors like you and me.

The sponsor of the offering (the general partner) invests sweat equity in the project. He/she is responsible for finding the property, raising funds from investors (limited partners) acquiring the property, managing the day-to-day operations of the project, usually following a 3-7-year business plan. For this, the sponsor is typically rewarded with 10%-25% of the project's equity and positive cash flow. This may seem like a lot, but remember that the sponsor is doing all the work. As the investors have no managerial responsibilities, this is about as passive as it gets. The investors simply receive their monthly or quarterly distributions as well as their share of the profits at the end of the project when the property gets sold.

The GP and the LP own the property together in the syndication and it is usually the goal to eventually sell the property at the end of the business plan's term at a higher valuation. The business plan spells out how the GP will manage the property and increase its value through capital improvements as well as reducing costs and increasing rents and other income.

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Syndicator

Someone who puts together a syndication, and is responsible for finding the property, raising funds from investors, acquiring the property, managing the day-to-day operations of the project, usually following a 3-7-year business plan.

Tower

Type of multifamily real estate. A high-rise apartment building with nine or more floors and at least one elevator.

Townhome

Type of multifamily real estate. Similar to the garden style, these are usually 2 or more stories build like row houses, and may include private yards.

Triplex

This is a building that is composed of three homes within one building.

Types of Multifamily

There are high rises, garden apartments, short-term rentals and traditional long-term rentals. There are also apartments catering to certain niches like senior communities, student housing, and assisted living facilities. Diversifying your investments across many of these types of investments can be beneficial.

Underwriting

The process of studying all data and circumstances for a property that help support certain conclusions, making pro forma statements possible.

Value-Add Property

A value-add property could be outdated or unkempt and need physical improvements or repairs due to neglect or operators lacking the funds to make improvements, and could be considered a class B or class C asset. There might also be operational challenges due to poor management and could have higher vacancy rates than other similar properties in a given area. Management problems, occupancy issues, and deferred maintenance are all key characteristics of a value-add opportunity. These projects often have little to no cash flow at the time of acquisition, yet have the potential to yield an incredible amount of cash flow once repairs are made or the management issues are addressed.

Part of the new operator's business plan might be to increase cash flow over the hold period by improving or repositioning the property. Examples include making physical improvements, increasing efforts to rent vacant units, improving the quality of tenants, reorganizing or improving the property management team, and lowering operating expenses wherever possible. All this usually forces appreciation of value for the project, so when it comes time to sell, investors get to share in the sometimes significant capital gains.

Workforce Housing

Type of multifamily real estate. Sometimes referred to as affordable housing, these are usually class B and C multifamily properties that cater to middle-income renters. The difference between workforce housing and affordable housing is that the former is for renters who make between 80% and 125% of the area's median income, where the latter is usually meant for people who make less than 80% of the median income. There are fewer amenities than higher-end apartment communities, and these serve renters who are priced out of the market for apartments in the more desirable locations. There has been an increasing demand in recent years, and possibly a shortage in some areas, for workforce housing, and represents excellent syndication investment opportunities.