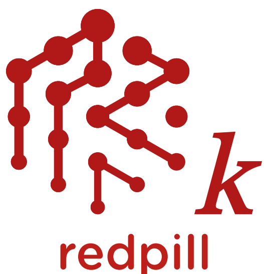
14 secrets of successful passive real estate investing

Hi. I'm going to be going over 14 secrets of investing in passive real estate. These are the things I wish someone had told me or things I had to learn the really hard way. You might even call it, "How not to lose millions of dollars when you start out."



Real estate is the most powerful way to accumulate wealth. More people have become millionaires through real estate than any other means. We know how to find the property, create a plan for improving the cashflow, negotiate the deal, and manage the asset. Your passive investment provides you with the opportunity to earn an income without the nine to five. We create a unique business strategy that fits your financial and investment goals. Get the financial freedom you need to do more of what you love. **We are Red Pill Kapital, with a K.**

1 Operator integrity (each GP)

You want to know about the operator integrity of each of the general partners. You want to know exactly what their experiences are. You are passive in this deal, but the general partner is active. They're responsible for maintaining and operating this specific investment for you. You're the customer.

But unfortunately, it's not that simple. The reality is being the customer, you have to be extremely well informed about the investment to the same level as the general partner, and not only that, you have to make sure that that general partner is going to be well behaved during the timeframe of your investment. You have to do a background check on each and every general partner. You want to make sure that you've done a UCC check. You want to make sure that there aren't any security law violations. You want to check their creditworthiness. You want to see how close they are to financial solvency or if they're using your money to solve a problem hidden somewhere else. Are they undergoing bankruptcy somewhere else and this is a way for them to raise a bunch of money and then take advantage of a situation where you're passive, they're active, they're in control, and they have your money?

You want to understand the specific roles of each team member

- Who's going to manage this asset?
- Who's going to manage ongoing after the purchase?
- Who found the deal?
- What's the relationship of the deal finder to the property?
- What's the relationship of the deal finder to the real estate agent?

You want to figure out who did the underwriting.

Is the underwriter somebody that's independent or is the underwriter somebody that's so dependent upon this deal going forward that they might create difficulty for you by changing the numbers or changing the perception or not adequately stress testing the deal?

You want to figure out how they're raising the capital, and that has a huge impact on your expected rates of return.

If the capital raise is being done in a global way and there's a lot of people coming in – potentially customers that could be passive – you're going to find out that your rates of return will drop. But if it's a limited raise, if it's just friends and family, it's a small group and it's not actively being marketed to the general public, you're going to find that your rates of return are higher.

You want to figure out who the key principal is.

Who's backing the loan? Who's got the assets that the bank is going to be looking to to come back? Because it's not going to be you. You're a passive. If this is for you, a passive investment, the money that you invested is the only money that you have at risk, but the key principal, whoever that is, they've got everything at risk. They're on the hook potentially for the entire loan.

Understand the roles of each team member

asset manager

deal finder

underwriter

key principle

2 Incentives integrity

The key thing is, do you know, do you like, do you trust the general partner? That's the most important thing. It's not so much the deal. It's the general partner.

You want to make sure that the general partner's incentives are aligned. You want to make sure that they've put money in the game, too, because if they didn't put any money in, they're not really aligned. Whether you win or lose, they've got nothing to lose. Now, there are going to be acquisition fees, no matter how you do it. There are always acquisition fees in any project, and the acquisition fees are not something you should run away from because if there's no acquisition fee, that means that you're basically taking a very significant gamble that they didn't look at a bunch of other deals. The acquisition fee pays for the general partners, whoever was doing the asset analysis, whoever was doing the underwriting to have looked at possibly hundreds of other deals and exclude those from an offering to say, *«Look, I looked at 50 other deals. I traveled to 25 other localities and those weren't good deals. I'm not even going to present those to you.»* But that stuff costs money, so the acquisition fee is used to defer or defray the cost for the deals that you didn't look at. It's to get rid of the bad deals.

Now, if you're going to do major construction—and I'm not talking about painting, I'm not talking about changing out a bathroom—but if you're going to do major construction roundup or you're going to massively rehab a project, there are going to be construction management fees.

5-10%

You want to make sure that they're between **five to 10 percent.** Obviously, the bigger the project, the greater the construction management fees. You're going to have to pay somebody to manage the construction because you're passive. You're not going to go out to the site. You're not going to be doing this yourself. If there's no incentive for the general partners to manage that construction well and efficiently, you don't get as good of a deal.

1-2%

The asset management fees are ongoing fees charged to this partnership, and what it is is typically between one and two percent, and they're used to manage the managers. You have to have somebody who manages the managers – somebody that directly interacts with a management company and makes and holds the management company accountable, to make sure that you're maximizing your depreciation, to maximizing your marketing, to make sure that all of your assets are protected. If there's no asset management fee, people are going to lose interest, and you want to make sure that's between **one to two percent.** That asset management fee says, *«Hey, look. We're going to be looking very closely at this project and we want to make sure that nobody screws this up for us.»*

30-50%

You want to make sure that the general partnership returns are only after your preferential return is paid first, and so there's usually a split. It's typically between **30 to 50 percent** of that annualized or quarterly or monthly return that gets paid to the general partner. This keeps them engaged because if that's not engaged, if there's not a heavy incentive for them to maximize your return on investment on a cash-flow basis, things can fall through the cracks because the end result is at the end when you sell the thing. That's an equity position, but the cashflow basis is what do you make every month? What do you make every quarter? Some partnerships pay out annually, but most of them pay out quarterly. You want to make sure that they maximize your cash flow and that they're sharing in that, but after they've paid your preferential return.

70:30 to 50:50

In terms of capital paid for a successful deal, that's the difference in price between what you purchased the asset at and what you're selling it at. Typically there's a split at that, and so that's typically a **70/30** all the way down to a 50/50 where you're getting 70 percent and the general partnership's getting 30 percent, or it could be **50/50** where you're getting 50 percent and the general partnership is getting 50 percent. I've seen some variations of this, and depending upon the class of stock, there may be some variations that have to occur, but that's your equity raise, so a big chunk of your money comes as cash flow on a monthly or quarterly or even yearly basis. The bigger chunk — the real income — comes when you sell the property or refinance the property.

3 Deal integrity

You're looking for the integrity of the deal itself now. You've trusted the partnership; you've trusted the people in the partnership. Their incentives are aligned, but now is this a good deal? This is very important. This determines how this deal operates, and in deal integrity, the number one thing you have to look at is the demographics. Is the area that you're investing in growing? Is it stable or is it dying?

You have to realize that real estate is hyper-local, and hyper-locality means neighborhood, street by street. It's not that I'm investing in Texas, it's not that I'm investing in San Antonio, a city in Texas, it's that I'm investing in this three-block or seven-block or 10-block or 14-block neighborhood. It's that hyper-local. You can't tell me that if I invest in Texas, I'm going to increase my real estate value by 7 percent because there are places in Texas that are going to increase their real estate value by 30 percent and there are some areas in Texas that are going to increase the real estate value negative 30 percent. So it's hyper-local. It's not the state, it's not the city, it's not a ZIP code. It's a neighborhood, and that hyper-locality is very important.

There are certain tools that we utilize to determine the hyper-locality of a neighborhood. You want to look at job growth in the region. People live in the region, but they live in a neighborhood, and very specifically jobs come to the region. They might be in industrial parks, but people don't live in industrial parks. They live in neighborhoods. You want to look at population growth for that city because it's almost impossible to get direct population growth for a neighborhood, but you can get population growth for the city.

You want to look at household income and its affordability.

Is the price that you're paying close to what it would cost for somebody to just go ahead and buy? Then there's a lot of competition for your product. If, on the other hand, the price that you're paying per unit is relatively low and the cost of them purchasing a similar amount of square footage is high, it's highly likely that they're going to rent instead. That concept is called affordability. It's a comparison for price to rent versus price to buy for a similar sort of asset.

When they underwrite this deal, if they're using non-recourse lenders, that's a really good thing because the non-recourse lenders are an additional set of eyes on this deal. They're going to hire an outside independent consultant or they're going to use an inside independent consultant who's going to stress test the deal. They're going to figure out: is the information being provided accurate or inaccurate? They're going to look at that cap rate. They're going to look and see what your start cap rate is. If it's a value-add deal, it doesn't matter so much, but if it's a stabilized deal, the cap rate is what you're going to be making, so you want to look at how this deal is being underwritten. Is this deal being written, underwritten, as a cap rate with a value add? Then you want to look. That incoming cap rate doesn't mean anything, but if this is a stabilized deal and your cap rate is 4 percent and your interest rate is 4 percent, it doesn't leave a lot of room to make cash flow. Now, it may appreciate over time, but the cap rate is going to determine your cash flow.

Demographics before underwriting

hyper-locality

population growth

job growth

household income and affordability

Underwriting this deal

non recourse lenders add additional layers of due diligence

cap rate and value add

You want to make sure that the deal is stress tested

- That means what would happen if occupancy dropped to its historic low?
- What would happen if prices would drop to their historic low?
- What would happen if cap rates went up?

Because the higher the cap rate, the lower the price, and so you want to be able to predict your monthly or quarterly income, and you want to predict your exit as well.

4 Property evaluation

You obviously need somebody that's going to look at that property in real time before you've invested. Typically, it's done with a property management company that's going to come in and long-term manage that deal. You want to make sure that each and every unit has been walked, that each unit has been memorialized by photography, so they've looked under the sinks and photographed the stuff, that they've looked at each appliance and categorized it.

- How many dishwashers will need to be replaced?
- How many refrigerators will need to be replaced?
- What's the likelihood going forward that we have to change this electric system?
- Are there GSCFIs in the wet spaces?

You want to look at each mechanical system.

What's the lifespan on the motors that are expected for this HVAC unit? One of the things — a horrible mistake that I've made — is I forgot to have a sewer scoped once. That was a $15,000 disaster.

You want to look at that usable lifespan of the roof.

I did a project once that I was able to identify that the roof was at the end of its usable lifespan, and right before closing when I got my roofing report back, I was able to get a $400,000 credit on a usable lifespan of a roof on a commercial strip center. It's very important that you know eyes wide open going into a project what's going to be happening. Foundation work may sometimes require a specialist. You can't just look at a foundation and say, *«Oh, this is awesome. This foundation looks fine.»* There are things that people hide in foundation work with stucco or dry wall that you can't identify right now, and they may move subtly over the next six months, a year, or five years, and then when you're trying to sell, somebody does a foundation report and it decreases your value by 30 percent, and all of a sudden the big profit that you were going to have doesn't even exist.

A lot of lenders require flood letters.

That determines, is this property in a flood zone? Now, you have to realize that flood letters change over time and historic areas that used to never flood are now starting to flood, so you want to get a professional evaluation. Is this area prone to flooding? When you do your memorialization of each unit, you'll be able to identify if there's mold underneath the sinks. You'll be able to identify if your tiles have asbestos in them. Is there lead in the paint? Are there other hazards that are lurking under the ground such as petroleum from a leaking gas station nearby? These are all environmental issues that become very significant because it's not just that you're buying this property – you're eventually going to be selling this property, and you may be selling to somebody who is very, very detail oriented, and this may destroy your value if you don't yourself become very, very detail oriented.

5 Comparative Market Analysis (CMA)

You want to make sure that they've done a comparative market analysis, not just of what's the value of this property because the value of the property and commercial is typically a derivative of cap rates.

What you want to figure out is that your comparative market analysis for rental rates going forward for this particular asset, this class of asset, this space, these kind of amenities, is accurate. Remember I said that real estate is hyper-local, so you can't use a rental rate comparison for a property that is on the other side of town. You can't use a rental rate comparison for something that might only be four or five blocks away if it's a different neighborhood.

So, I typically do all my comparative market analysis on a basis of **neighborhood,** and usually when I have a property team go out and look at the specific property that we're doing and we're taking photographs of each and every single unit and we're memorializing each and every single unit, the next day we do go out and do a comparative market analysis. We visit all of the local neighborhood apartments, all of the local neighborhood areas, and try to get an idea of what are these people charging and how relevant is our rental rate to their rental rate.

You want to be able to determine what's going to happen to your **rental rate** by your asset class, with your level of amenity, and based upon the demographics that you're both serving. If the apartment three blocks away has twice the household income that your apartments do, you're really living in two different neighborhoods, so there could be a significant difference.

I always do a **reputational search** on each and every unit because that tells me in terms of a multifamily, what's the reputation of the management company that's currently there? That's one of the easiest things to fix. Now, if it turns out it's a horrible result, then I may have to change signage and change the name because that's the only way I can get away from the original reputation, so I have to build that into my cost, that I'm going to have to re-market the entire system and change all of the signage. Typically, I also change the color scheme so that the drive-by looks totally different.

Neighborhood based, hyperlocal

Population growth

Reputational search

6 The value add plan

You want to look at their value-add plan if that's the way that they're going to be going. One of the things that I always look at is what's my occupancy or vacancy? If there's almost no vacancy, that could be a problem. If I'm running close to 100 percent occupancy, what that tells me is either the management company is really lazy because they don't want to raise rents and nobody wants to move, or I've completely distorted this market. Now, the other thing is if there's a high vacancy – i.e. a low occupancy – that could be a problem, too. Have I already reached the maximum amount of rentals that I can get to, or is it so mismanaged that I can't get customers in the door?

In my value-add plan, I also look for sources of net operating income. What are the other things that I can add that will generate me net operating income? Because the net operating income will determine the value because NOI divided by cap rate equals the value change that I'm going to get. So if I can get a slight increase in laundry or start charging some parking fees, if I can get some cable or internet fees, if I can start charging for pets, if I can force the tenants into paying a proportional share of the utilities, if I can increase the water efficiency, I've dramatically increased the net operating income. Based upon the cap rate for that area, I could have dramatically increased the value.

The areas that I look for in a value-add plan is I do marketing first. I increase the inflow of customers. Then I look at areas of increasing that operating income. Then I start doing things like curb appeal and kitchen and appliances and baths, and I only keep my rehab budget, which is a large capital expenditure, after I fix the first problems. It's a tiered approach. You don't want to do a major rehab budget and use your cashflow to pay for it if you haven't even fixed your marketing first. You want to get maximization of the lowest-hanging fruit first before you spend a ton of money on capital expenditure.

7 About this deal structure?

Now look at your deal structure. There are two kinds of essential deals that people look at: 506b and 506c. You want to know what the structure of that deal is? A 506b, you can sell for credit and say that you're an accredited investor or you're a sophisticated investor and they're letting you into the deal, but this deal isn't advertised to a lot of people. Usually I find that my rates of return are higher in a 506b.

A 506c says, «*Hey, I'm a verified accredited investor. Third parties verified me, but this deal might be advertised to a lot of people and it might be heavily advertised on Facebook and it might be advertised on other areas and portals.*» Frequently, I find that my rates of return are a little bit lower here. You want to know what your investment minimums are and what your investment maximums are because if your investment maximum is low and you're trying to deploy cash, your cash multiple may not be that good. I have a minimum amount that I want to invest and I want to know that I can deploy that capital and it's going to be safe and I'm going to get a multiple of that capital coming back.

You want to know what's the time element for your soft commitment and when do you go hard on your commitment and when do you have to actually transfer that capital? I'll talk about transferring the capital in a second.

You want to review the detailed subscription agreement. Was this professionally prepared? Did an attorney put this together? Does it make sense? Did you read the thing? I find that the private placement memorandums, most people don't even read. Take that nondisclosure that's in there very seriously. If you're taking the information and sharing it with friends, that's not cool because if they disclose that information, especially if there's information about tenants in there, you could jeopardize your position in this project and you could actually be sued. Take the nondisclosure very seriously in sharing that information outside you.

You want to know: should you visit the site? Can you delegate this? Most passive investors don't visit the site, but occasionally if you're in the neighborhood, if you live nearby, it might be worth your while to visit that site.

One of the biggest mistakes I've ever made was unfunding or transferring capital because I screwed up my routing numbers, so I always validate the routing by two different modalities – typically by a phone call, by email, or a text. I use two different methods to verify and validate that routing number so that my money doesn't end up in Uzbekistan.

8 Financial integrity

You want to look at the financial integrity of the deal. Have they set up strategic reserve accounts to hold capital expenditure budgets? Because you don't want to use cash flow for capital expenditure. Capital expenditure should be set aside at the beginning so you can predict it.

One of your biggest expenses in real estate is going to be your **taxes**, and you want to make sure that they're setting aside money through the year to pay for the taxes. You don't want a cash call on this thing at the end of the year. You want a separate **operating account.** That operating account is what the management company works out of, and then they sweep the operating account to the rest of the accounts.

You want to make sure that the reserve accounts are there so that there's an adequate amount of money for unexpected things and there's an adequate amount of money for expected things. You know that a particular lifespan of a roof is going to be 30 years. You know that refrigeration equipment lifespan is five years. You know that everything such as carpet has a certain lifespan. You know that flooring has a certain lifespan. You know that painting has a certain lifespan, so you want to be able to predict that and have reserve accounts that account for that in a continuous method. The longer the deal – the longer the length of the deal – the risk of the deal goes up because a lot more things can happen. Economic risks can happen, property risks can happen, and demographic shifts can happen, so the longer the length of the deal, your risk goes up. If it's a 20, 30-year deal, it's much riskier than a three- to five-year deal.

Most people think that the larger the deal, the higher the risk. That's simply not true. The larger deal decreases the risk, and the reason is because in a larger deal, you're forced to have professional third-party maintenance and management companies. You're forced to have additional oversight and you get economies of scale. In construction, you get economies of scale and maintenance. You get economies of scale in marketing, and individual occupancies have much lower individual impacts on your cash flow. The more the number of units, the greater the incremental income enhances the value. If you're trying to increase rent by $10 a unit in 10 units compared to $10 a unit in 100 units, the net operating income is much greater at the same cap rate, and so the value is tremendously greater.

9 Communication integrity

You want to make sure that they communicate with integrity. You don't want to get communications on a monthly or quarterly basis that have a bunch of fluff. You don't care about family pictures. You don't care about Fluffy the pet. You don't care about travel pictures. What you care about is the property.

I recommend that you have pictures and videos, and you also have net cash flows that go hand in hand with marketing reports, and all of this is archived so that you can go back and compare month over month over month and look at each of the reports and validate their integrity.

I set up a separate Excel spreadsheet for each individual investment that I go into and I archive all of the information in a single folder, and then I have a spreadsheet that tells me: This is my expected date of next payment, this is my expected rate of return, and when the deal opens and when the deal closes, I revalidate. I go back and look at what they promised and looked at what they delivered, and I want to make sure that they underpromised and end up overdelivering. I want to make sure that there's an integrity in that communication so that I don't get surprised by unusual things.

The management company should be generating a marketing funnel report for you.

- How many people called about the property?
- How many people came out and visited the property?
- How many people submitted an application for the property?
- How many people did we reject from that application?
- How many people did we accept from that application?
- How many people moved in?
- What's our expected occupancy a year from now, six months from now, a year and a half from now on a month-to-month basis so you can predict looking forward when people are vacating units?
- Do I need to gear up marketing the two months or the one month before a high vacancy is expected?

You want to make sure that there's a comparative market analysis being done in real time. You want to make sure that people are looking at the rental rate changes and you get that done at least on a monthly or quarterly basis so you can see where your property's positioned compared to the market. You want to be very wary of vacancy. Is my vacancy high or is my vacancy too low? If your vacancy is too low, that means you're not charging enough. What kills most deals is turnover. If you have tenants moving in and tenants moving out, you have to reset that unit nearly continuously. If you have to reset the unit, that costs significant amounts of money and may destroy your cashflow.

10 Compensation model

On the compensation model, look at the preferential return.

11 Deal exit

You want to look at the deal exit. Are they applying the right cap rate for the expected deal exit?

I typically increase my cap rate by 0.2 per year, so 20 basis points goes up per year of the hold. So in a five-year deal, I'm increasing my exit cap rate or my reversion cap rate, by 1 percent. This is really important because this is part of the stress test. Now, it may not go up by 1 percent, but what a 1 percent increase in cap rate does is it forces the value down of the project for the same NOI, and this gives me a better prediction of what I could exit this deal at. Now, I'm hoping that my cap rate stays the same or drops because then my value goes up dramatically, but I want to expect that it may go up, and it really depends on a lot of factors in the economy at the time of the exit.

That brings us to the concept of is the exit a hard exit or is there a lot of variability in it? I prefer a lot of variability because if there's an opportunity to hold a property for another year or to exit early by two years to get a better price, I want that executed.

You also want to look at the deal exit. Is this a refinance or are they reselling? You want to look at the contingency plans in case the general partnership becomes incapacitated. Let's say that it's a small partnership that's running the GP. What happens if that general partnership becomes incapacitated? Who's going to run this deal and how are they going to get you all the way to exit and make that money?

Some people are doing a lot of investment in opportunity zones because there's a deferral on your taxes in opportunity zones. This is not relevant to you if you're investing through an IRA. The opportunity zones really don't mean much to you. Now, if you're investing directly, opportunity zones do mean something to you, but the thing is a 10-year exit dramatically increases your economic risk. You're marrying this general partner for 10 years. You really have to vet that general partner, and usually most of my opportunity zone projects are significant value-add and rehabilitation, so that can have a very big impact.

12 Is this deal worth it?

At the end of the day, is this deal worth it? How much am I investing, how long is the deal, what's my return, how often do I get paid out, and what's the deal split?

That IRR really is impacted, and that IRR is internal rate of return. What that tells you is what is my net present cash flow or what's my net present cash for a future cash flow, and depending upon the timing of the distribution, it can dramatically change the IRR. That may or may not be relevant to you because if you're using your cash flow for living expenses, that IRR is really important, but if you're just simply accumulating the cash, that IRR may not be as relevant and your total return may be more relevant.

13 Deal metrics (beyond the pref and split)

You want to look at the deal metrics beyond simply the pref and the split. What's the cap rate against the interest rate? Is this a value-add? Is this not a value-add? What's your reversion cap rate? These are all relevant.

You want to look to make sure that they're using the leverage because if they're not using the leverage, and they're using only your money, it dramatically reduces your return because typically using leverage gives an extra set of eyes to the project with the bank. It's a one-to-five ratio and usually the interest rate is far below the cap rate, so you're making money off of the bank's money without taking a significant additional risk.

redpill

Cap Rate

interest rate | value add | reversion cap rate

You want to look at your cash-on-cash return. You want to look at your annualized return, which is all of your money back divided by the number of years. You want to look at your equity MURP multiple, which is how much money did I make against how much did I invest. IRR we've kind of gone over, which is what's my value of cash today based upon a future revenue of cash flow, and that can be quite detailed. That's something that I typically will plot out on an Excel spreadsheet and look at, but it's not really relevant as much to me as my annualized return rates.

14 Your personal situation impacts

How are you going to be investing? Is this through an LLC? Are you investing directly? Is this through a trust account? You want to look at does this project allow 1031 exchanges? If it does, they have to set up a tenants in common for you. Does this project accept IRA or Roth, and if it does, what's the impact to UBIT? If they use leverage, you're going to be paying taxes on some of this gain at the highest tax rate there is, and you can't escape that. You may end up paying trust taxes that are very significant.

What kind of investors are they taking? Is it 506b? Is it 506c? Are they taking accredited or are they taking sophisticated? Accredited is that you have an annual income of $200,000 yourself or $300,000 joint income for the last two years or an individual or joint net worth value exceeding $1 million. A sophisticated investor is somebody who knows something about this and is a friend, and the deal sponsor knows them well, and that's Aunt Sally who doesn't have a lot of money but wants to invest in the deal. That would be typically a 506b and it cannot be advertised.

You want to look at the time horizon.

Will I need this cash in the near future and does the time horizon match my requirements?
If I need the cash in two years but the time horizon on this deal is five, this is not a good deal for me.

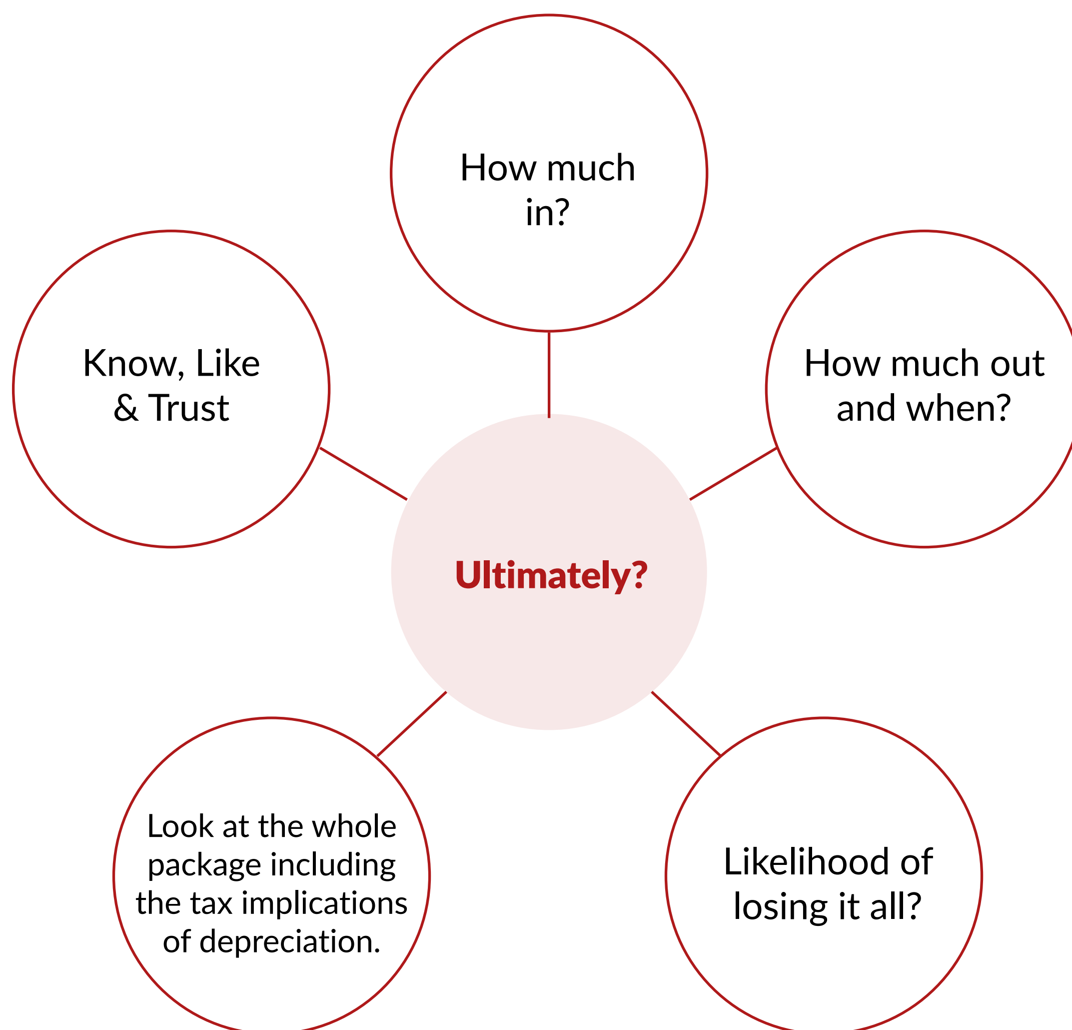
You want to look at what if

- What if I have an emergency situation? A medical situation?
- If I have to do a liquidation?
- What happens if my preferential returns are delayed?
- What happens if my entire investment is lost?
- How will this impact me?

It's not just the deal, it's you, and you need to make sure that you fit in well with this particular deal. Ultimately, how much am I putting in? How much do I get out and when? What's the likelihood of losing it all?

You've got to look at the whole package and look at the tax implications of depreciation, and most importantly, you have to know, like, and trust the deal sponsors.

Red Pill Kapital is a way for us to invest with you. If you're looking to enhance your financial wealth and truly live the life that you deserve, then this is for you. If you're an accredited investor and you're interested in learning more about passive investing, this is probably for you. If you're interested in investing alongside us, this is probably for you. The thing is, we don't need your money. We have money. We've done huge projects. What we want to do is do bigger projects, create more leverage. The bigger the project, the lower the risk, the higher the return. We only make money if you make money because we're aligned with you.



We search for value-added real estate for our passive commercial real estate partners, and we actively manage that investment long-term for a successful exit. We are Red Pill Kapital.
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