

The 9-Point Checklist

FOR PASSIVELY INVESTING IN
COMMERCIAL REAL ESTATE

PILLAR 10

ABOUT

In this checklist, we will be discussing the nine major items that should be reviewed, verified, and personally aligned with before pursuing any passive real estate investment. These items are not in any particular order but are the essentials for controlling the risk.

A wise man once said, **“Trust, but verify”**.

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THE OPERATOR

The first note is The Operator. One of the main reasons why good real estate deals go bad is due to the lack of strength of the operator.

The operator is responsible for locating the opportunity, structuring the deal, and executing the business plan accordingly. The operator is the individual(s) (usually a company) that oversee the day-to-day operation. If you cannot trust these individuals with your wallet, or spouse, then chances are, your interests are not aligned.

There are three main rules that should be followed when it comes to choosing an operator:

1. Audited Track Record
 - a. Has the operator operated in this market before?
 - b. Has the operator successfully executed a project like this before?
2. At least 2-Economic Cycles (The 2008 Financial Crisis is one)
 - a. Has the operator successfully navigated through at least two economic cycles? (Yes, things went bad, but some successfully navigated while others got caught)
3. Strong Co-Investment
 - a. What percentage of the equity needed is the operator contributing?
 - b. Where is the equity coming from? (we will get further into equity later on...)

THE OPERATOR

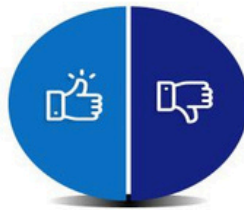
Audited Track Record Guidelines

Example DO'S

Asset Type:
Multifamily → Multifamily

Operating Location:
Phoenix → Phoenix

Project Type:
Stabilized → Stabilized



Example DON'TS

Asset Type:
Single Family → Multifamily

Operating Location:
Salt Lake City → Phoenix

Project Type:
Stabilized → Development

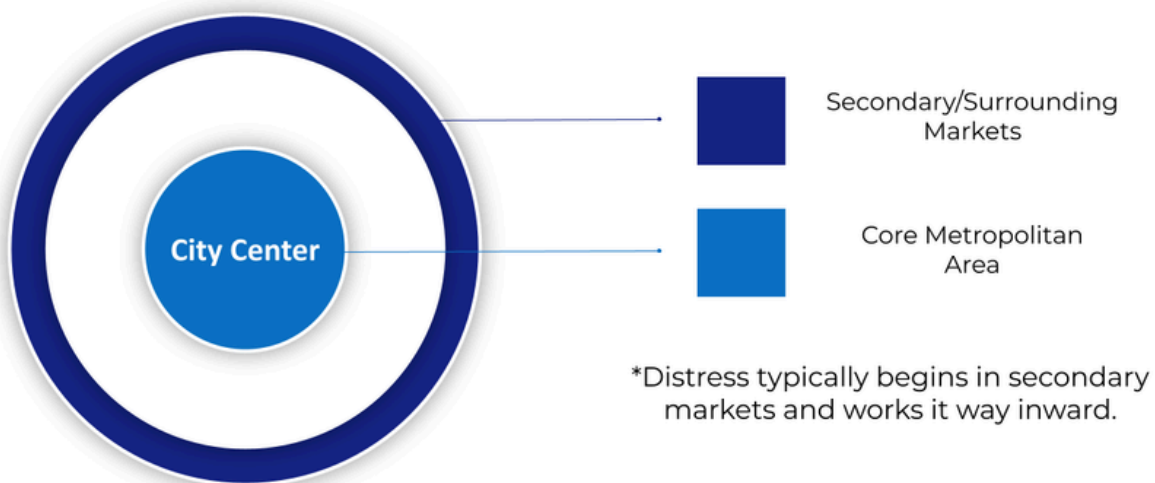
THE MARKET

The second note is The Market. No matter how strong an operator is, if the market does not support the opportunity for any reason, things can go south. When we say market, this means all types; overall economy, metro, and the health of the immediate submarket.

Here are three things that you should have a clear understanding of:

1. Macro Location (City/State)
 - a. What is the overall state of the economy in this particular metro?
 - b. What are the market drivers (ie Large Employers)
2. Micro Location (Submarket/Direct Location)
 - a. What is the overall state of the economy in the particular submarket?
 - b. Does this submarket support the opportunity?
3. Growth/Recovery
 - a. Is this location (Micro & Macro) a growth market or a market in recovery?

Market Distress Guideline



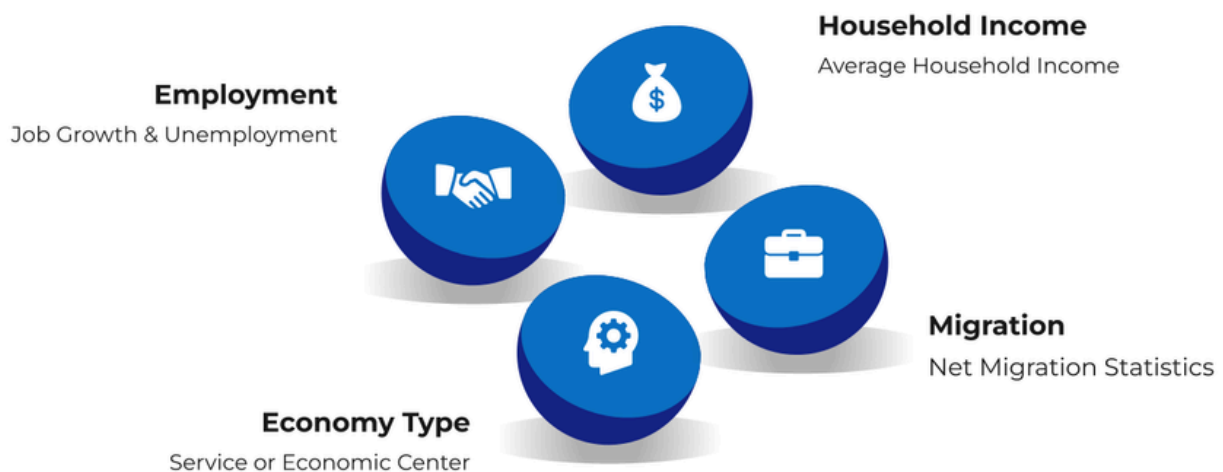
THE ASSET

The third note is The Asset. You know what they say, “It’s all about the deal”. Well, yes this is true. But is the asset supported? If so, by what? There are many different asset types and when we say ‘types’, we are talking about ALL types. Office, Industrial, Multifamily, Retail. Class A, B, C. Stabilized, Value Add or Opportunistic. All of these have different risk profiles that you need to consider before investing.

Here are a few of the questions you want to be asking:

- Is it implicitly functional or is it funky?
- Is the asset stabilized or non-stabilized?
- What are the risks associated with the project/asset type?
- Does the immediate market support this asset? What are the market drivers?
- No passion projects

Market Drivers Diagram



THE BASIS

The fourth note is The Basis. This is related to the cost of the investment compared to the history of the comparable market.

In today's market, and historical markets, operators overpay for assets. Overpaying for an asset with leverage is a time bomb for failure.

Getting a 'good deal' is not paying the market price, it's getting a discounted rate based on today's comparable assets.

Here are a few of the main points you want to have a clear understanding of:

1. How do we make money? (Both you as the investor, and the operator)
2. Comparable Properties (What are similar assets trading for? Have assets traded this high before? If not, why is this a separate circumstance?)
3. Exit Cap Rate (What is the projected Cap Rate at the sale or refinance? How is this determined? Is it realistic for the market to support this?) The operator should be more conservative with this number to over-perform on the investment.

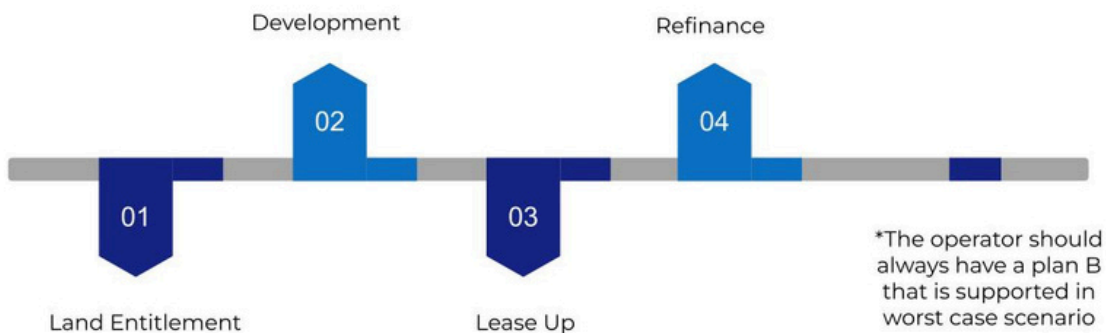
THE BUSINESS PLAN

The fifth note is The Business Plan. The opportunity always determines the business plan. Is the asset stabilized? Is it a value add deal? Is it raw land that needs entitlement? Depending on the answer, this will determine the proper business plan. But does the business plan align with the opportunity? And is the operator qualified to execute the business plan?

Here are some of the questions you should be asking:

- What 'events' need to happen to execute the business plan? (Ie Entitlement, Construction, Rehab, Lease-Up, Tenant Renewals, Etc.) Understanding what events need to occur in order for the business plan to succeed will help you determine the risk of those events failing.
- What is the exit strategy? What needs to happen for this to occur? What is the backup plan? (Yes, the operator should always have a back up plan, and that backup plan needs to be supported in worst-case scenarios)

Key Event Examples



THE DEBT

The sixth note is The Debt. A lot of investors do not understand the complexity that debt can have. Yes, the deal can be structured with a very 'simplified' capital structure with a Senior Loan at 80% LTV (Loan-to-value) and can have the rest of the equity split between the operator and traditional LP (Limited-partner) investors, but it can also be very complex.

The structure of debt can cause a project to be over-leveraged. So it is very important to understand this.

Here are some of the questions that you want to get answered:

- What is the Capital Structure?
- Who is the lender?
- Who is signing on the loan?
- Is there a guarantee?
- What's the recourse?
- What is the LTV or LTC (Loan-to-cost)?
- Who gets paid first? When does equity 'kick in'?
- What happens in the case of a default?
- Who is protected?

THE EQUITY

The seventh note is The Equity. There are two parts to this that we want to cover; The Operators Equity, and Common LP Equity.

First is the operator's equity. There are several ways that operators can contribute equity to an investment:

1. Cash Equity - This is real skin in the game and is good because the operator has something to lose.
2. Market Equity - This is Equity that is built into the project in the form of value (Ie Acquired at a heavily discounted price).
3. Syndicated Equity - This is using OPM (other people's money). Beware of operators that only use other people's money as they may become unmotivated when times get tough.
4. Large Investor or Limited Partner Equity - This is institutional or large LP Equity used for the majority of the equity. The final equity is from a close network of partners or friends and family. This can be good equity as the operator needs to protect their reputation.

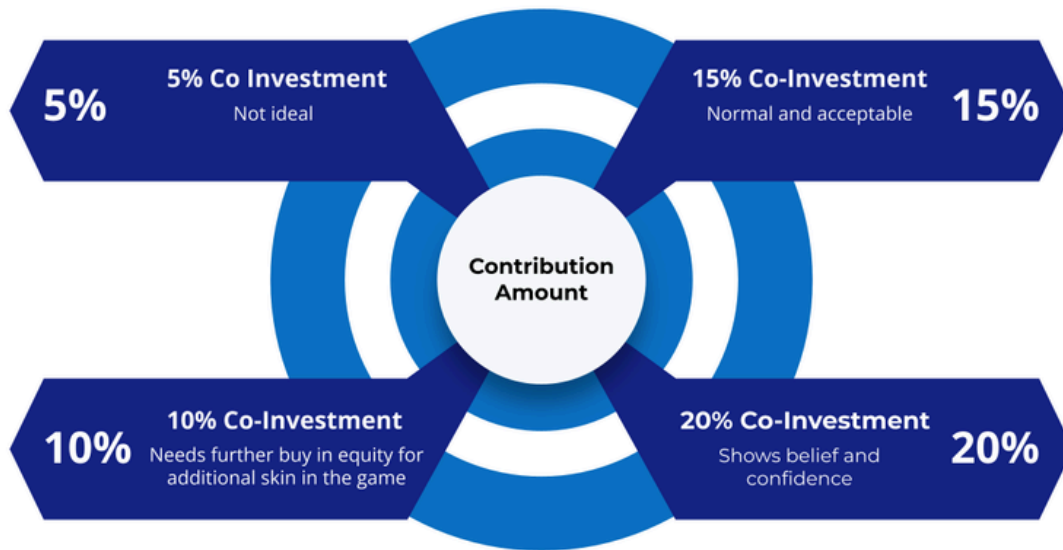
The second is the LP Equity. The reason why this is important is that depending on who the investors are and how many there are, can cause issues when things go soft. Remember, Not all equity is created equal...

Here are some of the questions you should be asking in terms of the operator's equity, and the limited partner equity:

- Where is the equity coming from?
- How much equity is being contributed by the operator?
- If the operator is using syndicated equity, whose capital is it?

THE EQUITY

Guidelines for Operator Co-Investment Amount



THE CAPITAL SOURCES AND USES

The eighth note is The Capital Sources and Uses. This goes in line with the Business Plan, the Debt, and the Equity. The uses of capital are important to understand as this is where things can become questionable.

Not all value is created equal. For example, the operator's business plan might include replacing the roofs, toilets, and light fixtures in hopes to raise rents. The problem is that tenants *expect* a working toilet, lights, and a roof.

Here are some of the Capital Uses you will want to understand:

- Acquisitions Cost (Purchase Price)
- Development/Rehab Costs (Detailed)
- Lender Costs (Organization, Interest Deposit, Reports, etc.)
- Equity Costs (Institutional and traditional LP)
- Return on Capital Expenditures

THE WATERFALL

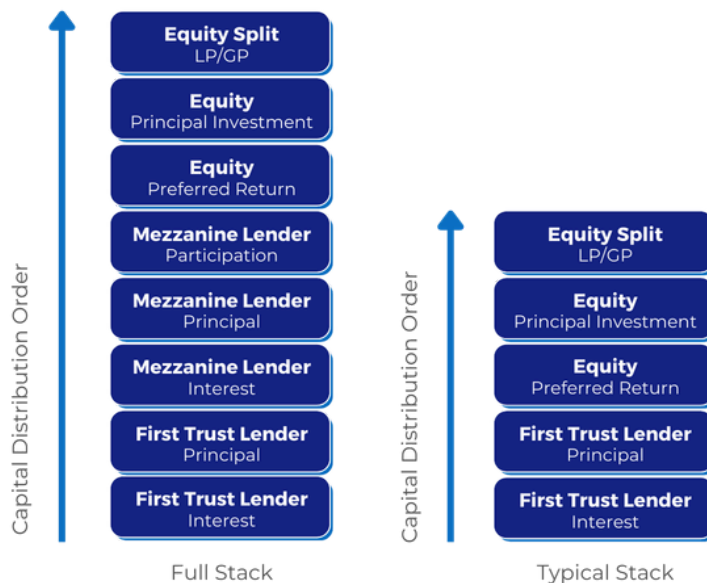
The ninth note is The Waterfall (how the beans are split). The waterfall is how the cash flow and profits are split up. This is where the fun comes in, but most people don't fully understand what a waterfall is. A waterfall is what it sounds like, if you were pouring water (AKA 'cash'), who gets paid when, and how much? The waterfall is outlined in the operating agreement and will differ for every deal and operator.

Waterfalls contain three things; the split, the hurdle, and the sponsors promote.

Here are some of the details that you need to understand:

- Is the operator's contribution subordinate to common equity? Or is it Pari-passu? (Who is paid back first)
- How is cash flow split after the debt is paid?
- Are there multiple hurdles?
- Is there a second promote?

Capital Stack Diagram



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We invest in exceptional assets, by combining our expertise with the track record of our best-in-class partners, to insulate and grow the wealth of our investor consortium.