The Power of Commercial Real Estate Investing

Part 1. True Wealth Defined

What is Wealth (and how can you acquire it)? The answer is simpler than you would guess...

It's been sought after and clamored for throughout recorded history. People are killed for it daily, and some say it’s the motive for every war

WEALTH

Though virtually everyone seeks it, most people haven't stopped to consider what it really is.
But have you taken the time to first define what wealth actually is?

Once we agree on the nature of true wealth, I’ll ask you to consider a second question: Are you on the path to possess true wealth?

This is really a simple lesson, and honestly, I could have summed it up in one paragraph. Maybe even in a sentence.

I'll get to that one sentence in a moment, but first, let me tell you where I'm **not** going in this particular lesson.

Those of you who know me know that I am first and foremost a spiritual person. My family, my goals, my business, income, and giving are all defined by higher priorities.

I could make a case that true wealth is giving back. Like Ebenezer Scrooge learned on that fateful Christmas Eve, most of us know that enriching the community and loving others will bring us the most fulfillment in this life.

I have chosen a path of investing my time, talent, and resources to change the world for the better. I consider that a wealthy life.

But that's not my point here.

I want to discuss the nature of true wealth in the material sense. And I believe that having this form of material wealth will provide you more options to attain wealth in every area of your life (spiritual, time, family, travel, giving back, etc.). Options that sometimes elude those whose days and nights are consumed by merely making ends meet.

So what is true wealth **not**?

Whether we admit it or not, I think we are all susceptible to believing that those with fancy homes and expensive cars have attained true wealth. It's easy to mistake the material trappings for true wealth, and while these may be an indicator of wealth, these symbols in themselves are not wealth. And we all know people who have faked it in an effort to look the part.

I even fell into this myself.

I recall the time I bought a late model Mercedes when I was in a particularly lean financial season. I was catering to those with wealth in my work role, and I reasoned that I needed to look the part.

I pulled into a private event (I was a speaker) with dozens of high net worth investors and assumed I'd fit right in. I was surprised to see that the average car on the lot was a Toyota. There were a few Volvos and BMWs, but more Chevys and Fords. (Was I at the wrong place?)

I had perhaps the nicest car there, but I was certainly not the most successful. And no one but the valet parking guy saw my car anyway. Fail.

I noted the same thing in the parking garage at Google headquarters in Mountain View California recently.

Many (admittedly not all) who have attained true wealth have nothing to prove in the realm of showy material possessions.

And many of you are aware that a pricey car and other tokens of wealth are often not assets anyway. They are depreciating liabilities.

Actually, in many cases they are assets...of someone else: The Local Banker. They provide a steady income stream for him, and so you become the means to increase his or her wealth. (How does that make you feel?)

Did you know that most of the Forbes 400 wealthiest Americans either acquired or maintain their wealth through commercial real estate? It's true. Do they know something that most of us don't? Or do they have access to investments that most of us only dream of?

The barriers to entry for investing in commercial real estate have locked the average investor out for decades. Keep reading this report to learn how you can overcome those barriers to gain access to this powerful asset class.

So what is true wealth?

Like I said, this could have been a very short lesson. I can summarize this in one sentence. Even better, one short equation. For you, learning this equation may be more valuable than understanding E=mc2. Here goes...

WEALTH = ASSETS THAT PRODUCE INCOME

If you don't read any of my other rambling below, I hope you will recall this simple equation. And I hope you think about its implications for your business and investing.
If you wish to read on, I'll develop a few more thoughts about my thesis.

Attaining assets that produce income means owning things that other people are willing to (actually must) trade a portion of their labor and income to obtain.

Timber is needed for housing and a thousand other things required by society. My son, Jonathon, has acquired land that will produce timber for the rest of his life. He owns assets that will produce income.

Other useful items are commercial buildings, rentable single-family homes, mineral rights, and cropland. Assets that can often produce income without full time effort on the part of their owner. Assets that people must utilize in order to eat, live, work, and get around.

The more income-producing assets you have, the wealthier you are. And the more assets you have that are insulated from downside risk, the better.

I enjoy reading Robert Helms and Russell Gray, aka The Real Estate Guys. Here's a relevant excerpt from one of their recent posts...

Intoxicated investors look at their balance sheet and celebrate their net worth...perhaps even borrowing heavily to spend on consumption.

In fact, this is EXACTLY what the government and banks WANT you to do.

Sober investors look at their balance sheet as merely a tool for building their CASH FLOW statement. Spending comes out of the productivity of the asset not its equity.

This is no small differentiation because **what you do with equity defines you as an investor**.

The investor who buys low, sells high, skims some spending money, then pushes the stack back in and rolls the dice again, needs to keep playing the game...or the cash flow stops.

You can be a full-time investor, but you're still on the treadmill.

The investor who buys low, then uses equity gains to acquire streams of positive cash flow will eventually **become free from the need to personally produce to eat**.

Robert Kiyosaki calls this out of the rat race and it's an enviable place to be.

The world is awash in paper (balance sheet) equity right now in stocks, real estate, and now cryptos. None of them are bad. Equity is awesome!

But the market giveth equity...and the market taketh equity away.

We think it’s smart to take equity off the table before Mean Mr. Market takes it first...and then **use**

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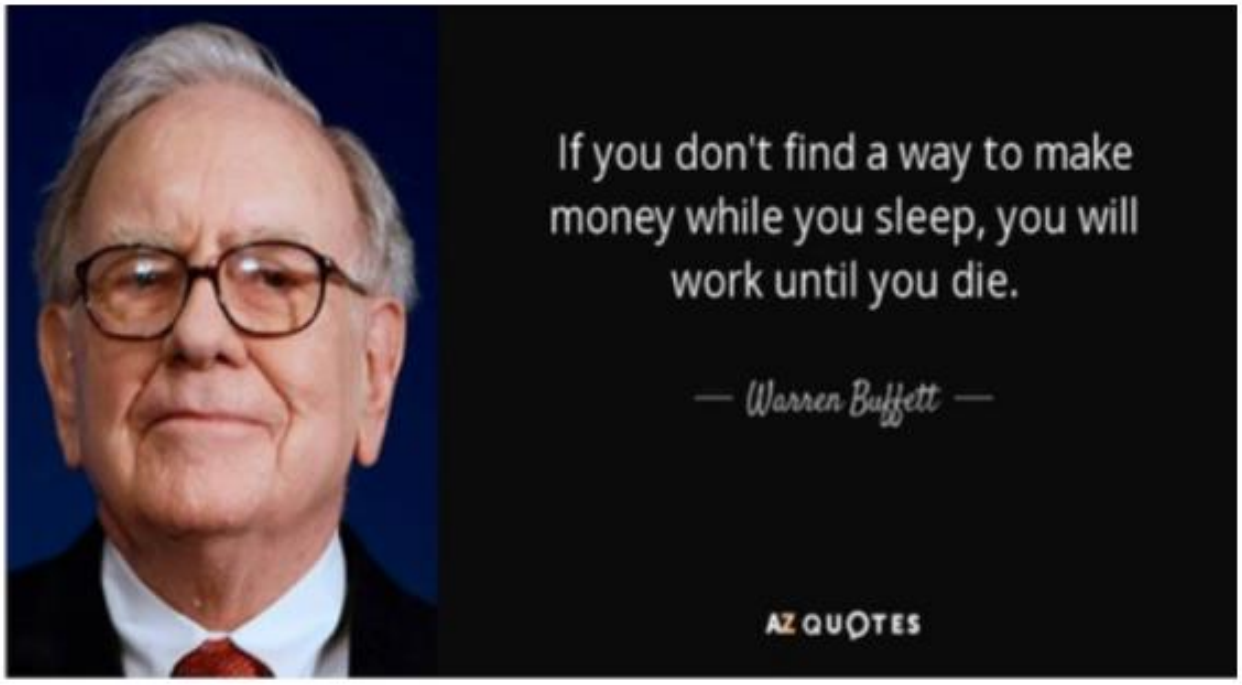
your new equity to acquire productivity...cash flow.

It's even better when you can pair equity with cheap long-term debt, so you can own MORE units of real value (properties) and income (tenants).

Of course, the right real estate is an ideal vehicle to acquire an income producing asset with cheap long term debt. If prices decline, the income provides a basis of value and control. And if prices take off, your bigger collection of assets will create even more equity faster.

What are some characteristics of desirable assets that produce income?

Produces stable, predictable cash flow.
Resistant to market cycles.
Tax-advantaged.
Able to be safely leveraged.
Evergreen. In perpetual demand, and not dethroned by the latest technological innovation, the mood on Wall Street, or a war in the Middle East.
Doesn't decline in value (may not skyrocket, but at least keeps up with inflation).
Low hassle. Generates income largely on its own.
Can be passed along to next generation.



How does this apply to real estate investing?

I've done a variety of things as an entrepreneur. In the real estate realm, I've operated as a residential REALTOR®, a builder, a residential and commercial developer, a house flipper, a waterfront lot flipper, the co-founder of a multifamily syndication firm, and the co-founder and manager of multiple commercial real estate funds.

While I believe that any of these paths (and many others) can be a route to wealth, I see a particularly strong fit in the attainment and operation of commercial self-storage, mobile home parks, and multifamily assets.

A number of years ago, I stood at a crossroads in my real estate career. I wasn't sure what to do next. I reviewed what I had done and realized that...

- When I was a residential REALTOR®, I was always dependent on the next deal.
- When I flipped waterfront lots, I was dependent on the popularity of a waterfront resort. No one had to have a lake home. (You can imagine how that worked out in 2008.) And I was always dependent on the next deal.
- When I was a builder, my profitability and sanity were dependent on finding and managing a very unreliable crew of guys whose priorities were not in their craft. (I'm saying that very nicely.) And I was dependent on the next deal.
- When I developed and sold-off a subdivision and a ground-up multifamily facility, I was rolling the dice on land, permits, construction, the local economy, and a variety of other factors. And I still needed the next deal.

I've chosen the path of investing in commercial properties because they really are assets that produce income. I view large scale self-storage, mobile home parks, and apartments as the perfect investment because they fulfill most of the criteria, I am looking for in an asset that generates income.

So, by my definition in this lesson at least commercial real estate owners are the holders of true wealth. Commercial real estate assets are...

1. Producers of stable, predictable cash flow.
2. Resistant to market cycles.
3. Tax-advantaged.
4. Able to be safely leveraged.
5. Evergreen. In perpetual demand, and not dethroned by the latest technological innovation, the mood on Wall Street, or a war in the Middle East.
6. Resistant to declines in value (may not skyrocket, but at least keep up with inflation).
7. Low hassle. Generates income largely on its own. (Assuming you partner with a great asset manager, invest in a syndication, or at least hire a great property manager.)
8. Can be passed along to next generation.

So how can you attain true wealth?

You are in the right place to find out. In the rest of this short ecourse, we will be exploring how investors of all types and sizes can capitalize on the opportunity to leverage time, knowledge, and capital to create a stable income stream and to build a bastion of wealth that can be passed on to the next generation and used to impact the world for good.

Part 2: The CRE Value Formula and The Power of Forced Appreciation

In the last lesson I explained my definition of true wealth. And I asked if you are on a path to achieve it. I made the case that true wealth equals assets that produce income. In this lesson, I'll explain the surprising formula that determines the value of that asset. And how safe leverage can help investors accelerate their returns and grow their assets.

Real estate investors as a whole will not receive these benefits. Only those who invest in commercial (by that I mean not small residential properties) real estate will enjoy these benefits. You can be successful investing in residential real estate. But you'll miss out on these benefits if you stop there. This is another level.

The Commercial Real Estate Profit and Value Formula

Commercial self-storage investing has compelling demographic, financial and operational drivers that got my attention and the attention of many of our investors. The return-to-risk profile is surprisingly strong. Check out this graphic from Thomson Reuters:

If you have invested in any of the asset classes in this graph...or if you have been burned by swinging for the fence and missing a few times...then this graph alone should be enough to get your attention. It's not easy to decipher this graph at a glance.

If you're a smart investor – and I know you are since you're taking this eCourse – your goal should be to be as high as possible on the vertical (return) axis. And as far to the left as possible on the horizontal (risk/volatility) axis.

Take a close look. Note that core commercial real estate has by far the best risk-adjusted returns of the major asset classes. This analysis applies to all core commercial real estate. ***The risk-adjusted returns of self-storage, manufactured housing, and multifamily shine brightly within this class, making the case for these three sectors even more compelling than commercial real estate in general.***

The Four Pillars of Return in Commercial Real Estate

"So, Paul," I hear some of you asking, "you are trumpeting the marvelous returns and limited downside of commercial real estate investing. How are these returns derived?"
I'm glad you asked. Return on Investment is derived from four components. CAPT for short. Not a great acronym, but better than CATP. (Say it out loud if you didn't get it.)

C = Cash Return

A = Appreciation

P = Principal Paydown

T = Tax Benefits

CAPT 1 = C: Cash Return

This is pretty self-evident. This return is derived from the free cash flow of the property. Thanks to accelerated depreciation, it's likely that your cash returns will be higher – sometimes quite a bit higher – than the taxable income on your K-1.

Of course, this will vary widely, but for the purpose of this report, here's a very rough estimate on how your cash returns could shake out based on $100 of gross operating income…

Gross Income $100

Less Operating Expenses $34

Net Income $66

Less Capital Reserves $4

Less Loan Principal & Interest $26

Less Asset Management Fees $2

Free Cash Flow $34

Without getting any deeper into the weeds, let's just say that this free cash flow represents a 4% Return on the value of the asset (ROA). That doesn't sound very exciting, right?

But the Return on Equity (cash invested) is much higher. Why? **Safe Leverage**. If the total debt as a percentage of the asset value is 2/3 (66.7% LTV), then the cash invested will be only 1/3 of the asset value, so the cash-on-cash return on equity for this example would be about 4% times 3 = 12%.

Typical cash-on-cash returns for self-storage facilities are between 3% and 7% early on, and perhaps about 12% or more later in the ownership period. (I recently invested in one that started at about 8% and is up to over 20% now.) But that's not all you get...

CAPT 2 = A: Appreciation

The Value of a stabilized commercial asset is generally the Net Operating Income (NOI) divided by the Cap Rate.

While both of these numbers are subject to some market forces beyond the operator/investor's control, there are many factors that are controllable through careful planning and execution. This is where I think value-add projects shine in the realm of commercial real estate. Since appreciation is a function of both NOI and Cap Rate, I will be discussing both in detail below.

Improving Net Operating Income is based on increasing rental income and other income while hopefully maintaining or decreasing operating costs as a percentage of income. Value-add properties provide an opportunity for the new owner to achieve a disproportionately high ROI on capital and management improvements made to the property.

This may be derived from a long list of factors, but a few examples in the self-storage realm include increasing rents, occupancy and other income by:

- Improving the property's interior and exterior appearance and functionality.
- Increasing the effectiveness of marketing.
- Adding new (typically climate-controlled) self-storage buildings.
- Adding or improving revenue centers like truck rental, late fees, administration fees, and insurance sales.
- Adding or improving a showroom with point-of-sale items like locks, boxes, tape, and scissors.

Net Operating Income may also be improved by reducing expenses. A good asset manager and property manager will have dozens of ways to achieve this. Examples of expense categories to manage include:

- Payroll and benefits
- Property taxes
- Insurance
- Utilities
- Administration and management expenses
- Repairs and maintenance
- Eliminating ineffective marketing expenditures

Now that we've talked about the role of NOI in driving appreciation, let's move on to Cap Rate. Your cap rate (capitalization rate) represents the market's evaluation of your un-leveraged yield for that asset class in that market.

Our team generally likes to invest in markets where cap rates range from 6% to 8%. Cap rates on

the lower end of the spectrum (higher-priced asset purchases) can be managed by aggressive rent growth in the first few years and through interest-only loans (typically available for up to three to five years).

Let's take a second to see what this kind of cap rate means to investors. A 1,000-unit self-storage property with a net operating income of $1.2 million in 7% cap rate economy is valued at about $17.1 million ($1.2M ÷ 7%). That same property at the same net income will be valued at $21.8 million if cap rates tighten to 5.5%.

Even if this owner did nothing to improve his property and income, the value went up substantially. (Of course, investing in value-add properties means you will be taking aggressive actions to improve the property, the rents and the net income – regardless of the market. The value-adds can often more than compensate for a negative move in cap rate.)

So, what impact could a change like this one has on the value of the investors' equity? Continuing the example. Income was held constant, but the cap rate changed from 7% to 5.5%. (This can happen through economic factors, or by improving the asset to sell to a REIT.) The value of the asset moved from $17.1 million to $21.8 million, a healthy 27.5% increase in asset value.

But it's better than that...

The value to the investors is significantly magnified by leverage. If this property has 60% leverage, which is generally considered a safe level, you can multiply the Return on Asset (ROA) by 2.5x to get the Return on Equity (ROE). The math on this is ROA * 1 ÷ (1 minus LTV) so ROA * 1 ÷ (1 – 0.6) = 2.5x in this case.

So, to calculate the impact on investor equity, multiply the 27.5% increase in asset value times 2.5x and the appreciation to equity is over 68%. *Just from the change in cap rate!* Do you see why smart value-add operators want to acquire assets that can be improved and sold to REITs and other institutional buyers?

CAPT 3 = P: Principal Paydown

This is pretty simple, and it may not even sound like it should be part of the return. But it is cash flow that could have been distributed to the investors but instead is used to increase in equity along the way, so it is certainly part of the return. It consists of the regular paydown of your mortgage balance as part of your monthly debt payments. Your commercial tenants pay down your mortgage while you sleep, and you do nothing special to achieve this benefit.

This kicks in after any interest-only period ends (if applicable). The increase in equity typically amounts to a 2% to 4% return annually. As an investor, you won't see any benefit from this in your quarterly distribution, but you will experience this benefit at the time of debt refinance or the sale of the property.

CAPT 4 = T: Tax Benefits

"If the American public knew how little we are taxed, we'd have a revolt on our hands!" So quoted a friend of mine before he launched into an explanation of how he and his investors could parlay $20 million cash into a $210 million commercial real estate portfolio over two decades...pocket $131 million along the way...and pay virtually no taxes. All legal and ethical.

The Value Equation - Putting it All Together

This is possibly the key takeaway from this lesson, and it applies to self-storage, manufactured housing, multifamily, and all types of commercial real estate. This is where the lightbulb went on for me, as it has for so many others.

There is a reason that most of the Forbes 400, the wealthiest of the wealthy, made their money in commercial real estate or are buying it to sustain and propagate their wealth. We talked about this in the previous lesson. This is the singular reason, more than others, that I tell my kids and others that...

If I would have known about the power of commercial real estate to grow my income and increase my wealth, I would never have done anything else.

If I was still in my twenties I don't know if I would have had the humility to listen to my mid-fifty's self. But you can listen. You're likely younger than me, but regardless of your age, I hope you will read this carefully and consider what I'm saying.

The value of a commercial real estate asset is unlike the value of residential real estate. Residential real estate is generally valued based on comparable properties. No matter how nicely you fix up your home, Chip and Joanna Gaines Jr., your value will still be limited by the homes in the neighborhood.

Not so with commercial real estate. The value equation for commercial real estate is:

Value = Net Operating Income ÷ Cap Rate

Buyers of stabilized commercial real estate are buying an income stream. Yes, they're also buying dirt and bricks and sticks and sheet metal and rivets. But they're generally focused on the income stream.

And recall from yesterday's lesson that acquiring an income stream is essentially acquiring true wealth. ***True wealth = Assets that produce Income****.*

(And they may pay a premium for income potential as well. In other words, if you have additional storage buildings or apartments or mobile home pads that were just built and are not yet leased, you should get a value assigned for those as well, but this is the exception to the general formula.)

So, your mission...if you choose to accept it...is to (drumroll...drumroll please)...

Increase the Numerator and Compress the Denominator in the Value Equation.

Yep, it's that simple. Well, maybe not simple, but certainly straightforward. We've talked about driving up revenue and driving down costs. These are the components of the numerator. We also talked about compressing the cap rate. This is the denominator. Let's put it all together with an example.

A Real-Life Example

Disclaimer: I am not projecting the following returns for this asset inside our growth fund. We are targeting 19% total annual returns for the fund over the course of seven years. Some of the

numbers below are theoretical in nature and cannot be accurately projected in advance.

My firm is currently partnering with an operator with decades of collective experience in buying value-add deals. Self-Storage assets that are doing "just fine" in their semi-passive mom-and-pop-owned state, but could be extremely profitable if run by a pro. This operator forces appreciation and adds profit through management efficiencies, expansion, and a variety of operating and marketing techniques.

Last month we invested with him in an asset in the Carolinas. My business partner was on the ground there for two days recently, and we are excited about seeing our operator/partner acquire it and transform it into a profit machine. Our investors are excited, too.

Here are a few highlights...

- This self-storage facility has extra land with road frontage along a major four-lane highway. (It's currently on a side street behind the highway. Visibility will go from poor to awesome.) The current scrub bushes and trees will be replaced with a beautiful new showroom and signage.
- The showroom will provide extra income in the form of boxes, tape, scissors, and locks for sale. And it provides a nice place to interact with customers.
- The operator will partner with U-Haul and potentially add a few thousand per month to the bottom line. This could have the "side benefit" of increasing occupancy 3 to 5%.
- The operator will use some of the extra land to build a beautiful climate-controlled building which will increase revenue and net income.
- The facility and all its competitors are almost completely full, and the current operator's rents are about 25% below average. Rents should be able to be increased by 20 to 25% with little effort, and maybe more after upgrading the frontage, signage, and adding a showroom.
- This operator has a great track record of selling his stabilized assets to institutional buyers like REITs. He may be able to sell at a compressed cap rate which would result in a premium price.

Let's look at the potential of a few of these items on profitability.

- Increasing rents by up to 25% will increase profits substantially – perhaps 30% since costs won't necessarily increase. The effect on the value of the asset is projected at +30% (easy math: Value = Income ÷ Cap Rate). But the effect to equity investors is much higher due to leverage. With an LTV of about 66%, the impact to equity appreciation is 30% ÷ (1 - 0.66) = 88%+. (Potential of 88% equity appreciation from just raising rates!)
- If he bought at a 7% cap rate and sold at a 5.4% cap rate, which is typical, this is a 29.6% increase in value in itself. (Dividing the same income by .054 versus .070 will result in a 29.6% higher sales price.) When multiplied by the leverage effect (29.6% ÷ (1 - .66)), this is another 88% increase in the value of the equity.
- There is also increased income from point of sale items, U-Haul, marketing improvements and more. Assume increased net operating income of 15% from all of this. This impacts the asset value by 15%, and the equity value by 15% ÷ (1 - .66) = 44%+.

There are quite a few more ways this operator has successfully increased income and value in past projects. I didn't even count the value of adding a large new climate-controlled building for example. The combined total asset appreciation from the three changes documented above is arguably 74% (30 + 29 + 15%).

When applying leverage, this arguably results in an increased equity value of 217%. The math on this is 74% ÷ (1 - .66) = 74% ÷ 0.34 = 217%. If this takes five years, that's equity appreciation of 43% annually.

This doesn't count the ongoing cash-on-cash return from the facility, which is projected at about 8% annually to investors. This brings the projected total return to over 50% annually.

As you can see, the cumulative effect of all of these value-adds translates to an asset that has a much higher value to the buyer than it did for the seller. This provides a great margin of safety for the right buyer that has located the right asset at a fair price.

Does this mean the buyer should willingly overpay? No. But in these days of inflated prices, it is great to have a strategy that allows for a purchase like this. And the margin of safety adds to the recession-resistant nature of value-add self-storage.

Note that this is not free or easy money. This is the result of years of experience, a great operation, relationships with the right sellers and buyers, and a lot of hard work.

But the payoffs to the operator and our investors are a beautiful thing. This is why my firm is spending a lot of our time creating relationships with these types of operators. And this is why our investors are co-investing millions in deals like this one and many more.

Would you like to learn more?

We'd love to hear from you. Just reply to this email.

You may review this lesson and think, "Yeah, right. It sounds good, but I'm not in a position...nor do I
have the desire...to buy a self-storage facility, a mobile home park, or an apartment building. Or any other commercial real estate asset. I can't see it happening."

I was talking with a prospective investor recently. She was an American living in Europe who was struggling with the thought of owning and operating real estate from across the Atlantic. She was trying to buy duplexes or single-family homes.

After talking through what it might look like for her to invest passively instead, in a syndication, the lightbulb suddenly turned on for her. She exclaimed,

"Why should I work harder than I need to...to make less than I could?"

Part 3: The Surprising Tax Benefits of Commercial Real Estate Investing

Death and Taxes May No Longer Be Mandatory

"If the American public knew how little we are taxed; we'd have a revolt on our hands!"

This California friend and fellow commercial investor was right. It's really true. And it's one of the reasons that, after a multi-faceted career of a variety of entrepreneurial ventures, I have thrown my efforts completely into the commercial real estate investment ring.

I had only been in the commercial investing world for a few years when this friend showed me how he could take $20 million of an investor's money and leverage it to produce $210 million in commercial real estate assets over 20 years. Throwing off a healthy $131 million in cash flow (to the investor) from years 11 through 20. That seemed amazing...but he had math to prove it.

Then he really amazed me. "How much do you think that investor might pay in taxes over that 20-year period?" he asked. "There's no guarantee, since everyone's situation is different, but I can see how he could pay as little as a few hundred thousand dollars. Or even zero."

Wait. A few hundred thousand dollars tax...on a $131 million cash flow stream? Like I said, some investors got into commercial real estate investing long before the big demographic shift...for the tax benefits alone.

I hired a professional Tax Strategist several years ago, when my partner and I were building a Hyatt hotel. He and my CPA know the mechanics. So, I can focus on other things. My goal in this lesson is not to give you the mechanics behind the curtain, but to continue our conversation of these topics in layman's terms. (This is why I often say "probably" or "likely" in the rest of this lesson. I think I'm likely often right on most of the items...probably even most of the time.)

Two things to note...

First: These tax benefits are not automatically available to all real estate investors. These benefits are available to those who have direct ownership and receive a K-1.
Second, an expected disclaimer...

Expected Disclaimer

Before I proceed, I need to make a few things crystal clear:

- I am not a CPA or tax professional. I cannot speak to your specific tax situation, and I cannot tell you if all – or any – of these tax-advantaged strategies will work for you.
- Furthermore, I can't verify the accuracy of the information in this lesson. I, and many investors across the nation, utilize these taxes benefits year-in and year-out. But that doesn't mean we all have an intricate knowledge of the mechanics behind them. I don't have to understand how the Internet really works to enjoy its benefits. Same here. You and I don't have to study the details of these tax strategies to enjoy their benefits.
- Since this was researched and published at a given point in time, it is possible that the codes and interpretations and rulings affecting these topics may have changed by the time you read this. And there are definitely state laws that are different from these generalizations I'm

discussing. More reasons to check with your own tax strategist or accountant. **So, what are these amazing tax benefits? Read on...**

> If you take $1.00 and double, it [daily] tax-free for 20 days it's worth $1,048,576 (over a million dollars). Take that same $1.00, taxed [every day] at 30%, it will be worth only about $40,640 — A LOSS of a MILLION DOLLARS! Why is this so? Because with tax-free compounding, earnings accumulate not only on the principal amount of money but also accumulate on the tax-free earnings as well. ("Earnings on Earnings".) Thus, compounding combines earning power on principal and earning power on interest. Compounding has been called the "8th wonder of the world," a "miracle". Compounding money at high rates of tax-free return is a definite advantage of real estate, especially with a great tax plan.

Direct Investment

When you invest in stocks or bonds, including a REIT (real estate investment trust), you are investing in a corporation. An entity that owns things and makes profits. If you work with the right Sponsor, you should be able to invest directly in commercial real estate. You will be a fractional owner of the property you are investing in, through a limited partnership, a single use LLC or other entity established just for the ownership of that property.
How do you know if you are a direct investor or not? If you are a direct investor you should be getting a K-1. If not, you're likely getting a 1099. This is important, because it positions you to take advantage of the other tax benefits of this profitable asset class.

Hire a Tax Strategist

Ed, a friend and fellow commercial real estate investor, told me the story of why he hired a tax strategist. As a real estate investor and real estate broker, Ed made a lot of profit over a lot of years. And he had a whopping tax bill to prove it.
He once read an article about a surprising tax-savings tip. He met with his CPA to share it, and the CPA agreed that it was a great idea, and that they should start that right away. And maybe even re-file for a few years to capture some of these benefits.
Ed, a bit irritated, pressed his accountant a little further: "Why didn't you tell me about this before?" His CPA answered (to this effect): "You pay me to do your taxes and oversee your bookkeeping. You don't pay me to be a tax strategist. I just take what you give me and file your returns. There are probably dozens of ways we could save money on your returns. But you hadn't really asked me about this. So, I hadn't researched it.

What??

When I first read this story on Ed's blog post, I was irritated for him. And his wife and kids. He would never be able to recover the money he flushed down the toilet over decades.
He later said that it was worse than he had posted. He said he spent over $1 million in taxes over the past decade leading up to his revelation. But in the decade since, he hired a tax strategist and he paid exactly zero to Uncle Sam. **Zero!**

Again, that wouldn't apply to everyone, but even if you could save half that much, wouldn't you want to know how? To be clear, I know Ed. He is a high-integrity guy, and I believe he files honest returns. He is conservative by nature. That's how tax-beneficial this asset class can be!
Hopefully your CPA is better than that one. But I encourage you to be sure he or she is highly

ethical, and at the same time looking for every possible tax advantage for you. I hired the same tax strategist/CPA that saves Ed over $100k annually. He has saved me hundreds of thousands on taxes since I started working with him. One more note: If you invest with a great Sponsor, they will solve many of these tax issues for you. They should know about these issues and manage most of them on your behalf.

> *"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."* - Judge Learned Hand - 2nd District Court of Appeals - 1934.

Return of Capital

One of the issues your Sponsor will decide is how to treat cash distributions as they are disbursed. It is possible that your cash returns (or a portion of them) may be treated as a "return of capital" rather than taxable returns on investment. Depending on the structure of the investment, all of your distributions up to the full amount of your investment could be treated this way, and perhaps be non-taxable as a result. This will affect your basis in the asset and may result in higher taxes later. Ask your CPA and Sponsor for details about what would be best for your situation.

Accelerated Depreciation through Cost Segregation

Depreciation is a method for allocating the cost of a tangible asset over its useful life. Since the IRS would not allow a million-dollar tax deduction in the year of that million-dollar purchase (in most cases), the million dollars is allocated via formula over the projected useful life of that asset. This provides a deduction to the income for the owner in each year the asset is depreciated.

> If you're having trouble sleeping, you can check out the IRS depreciation code for yourself: https://www.irs.gov/publications/p946

For example, if a machine is purchased for a million dollars, and its useful life is 10 years, it would (typically – if straight line) be depreciated at $100,000 annually. If a million-dollar building that houses that machine will be usable for decades, it might be depreciated over 39 years (typical IRS categories for permanent structures include 27.5 years and 39 years – but there are others). Land is not depreciable since its value does not typically drop with use over time.

As a direct, fractional owner of commercial real estate, you get a direct benefit from the financial depreciation of the asset. This means your income will be reduced by the amount of the asset's depreciation that year. It is very likely, after making a new investment in a commercial property, that you will have many years where you get a healthy quarterly dividend check, but your annual K-1 shows a loss. (This is completely legit and above board of course.)

Your CPA undoubtedly knows this. You probably yawned as you skimmed through it. But you may not have been aware, and some accountants may not bother to tell you, that there is a way to dramatically accelerate your income deductions and tax savings using componentized depreciation,

aka cost segregation.

Here's how it works in summary. A commercial real estate asset usually has components that are personal property. These wear out faster and need to be replaced more frequently than the structure as a whole. These components can be more quickly depreciated than the building itself.

> The IRS code for Cost Segregation may actually be slightly more interesting than the last link on basic depreciation: https://www.irs.gov/businesses/cost-segregation-audit-techniques-guide-chapter-2-legal-framework

For example, a self-storage building may have a 39-year life for depreciation purposes. But many elements in and around the facility may have a much shorter life and can be depreciated much sooner. These may include land improvements like pavement, landscaping, parking lot striping, and outdoor lighting (typically 15-year depreciable life). Other items like doors, HVAC, and roofs can likely be depreciated over 15 years as well.
It may include signs, office furnishings, flooring, lighting, plumbing fixtures, cabinets, shelving, technology, security/video systems, and appliances. Many of these can probably be depreciated on a 5-year schedule. This may not sound like a big deal, but trust me, it can be an enormous tax savings over many years. We recently got a cost segregation study on a commercial asset we own, and it helped accelerate the tax savings quite a bit.
I will tell you that the benefit of cost segregation studies is not as cut and dry for self-storage as it is for some asset classes like multifamily. Some operators, especially those who buy and sell properties on a short timeline, find that just the general tax write-offs for commercial real estate are adequate without the acceleration.

Correctly Classify Fully Deductible Repairs

It is easy for an uninformed clerk to classify all property repair and rehab expenses as capital expenditures (Cap-Ex). Cap-Ex expenditures are often depreciated over many years, as discussed above. Repairs to the property, however, are generally classified as expenses in the current year. These expenses do not have to be spread out over years.
A professional commercial real estate accountant knows how to use the tax code to be sure every possible repair is deductible in the current period. A great asset manager will know the right questions to ask to be sure this is being maximized on behalf of his investors.

Refinance Tax-Free

Ever refinanced your home? Were you able to pull equity out of it to use for something you wanted? How much tax did you pay?
If your commercial real estate asset has grown in value, as it should if operated well in a stable economic environment, you don't have to wait until you sell the property to safely extract some of the accumulated equity. Refinancing your commercial investment can be a great way to put cash in your pocket with no tax consequence.

If your Sponsor is considering this option, he will have a lender underwriting the deal, so he will likely not extract so much equity that it leaves the property short on operating capital or underwater in the event of a downturn. Nevertheless, you should ask your Sponsor how the refinance affects the Debt Service Coverage Ratio (DSCR) and how many months of principal and interest will be held in reserve to cover contingencies (we like to hold six months or more).

Debt Service Coverage Ratio (DSCR) aka Debt Coverage Ratio (DCR): The ratio of cash available to the mortgage payment. This is a measure of the safety of the debt. Lenders typically want to see a minimum ratio of 1.3x (130%), but I like our projects to be at least 1.4x in the worst year.

Here's an example of how this could work. Note that I am being overly simplistic for the sake of space. In the real world, I'd be calculating closing costs, capital improvements, and many other items.

Imagine you bought a 500-unit self-storage asset for $10 million with a seven-year loan of $7,500,000 (75% LTV – loan-to-value ratio). The loan was interest-only for the first few years. Note that total equity is more than $2,500,000 since there are closing costs and fees plus capital improvement funds that are raised upfront.

The 7th year is upon you, and the cap rate is stable. Between your upgrades and strong demographics nationally, your Net Operating Income has gone up by 35%. The value of your property, which is the NOI divided by the cap rate (assume the same as when it was purchased), has therefore gone up 35% as well, to $13,500,000.

During the seven years, you have paid down the mortgage balance 12.6%, from $7,500,000 to about $6,555,000. The owners' equity was $2,500,000 at purchase. It has now grown to $6,945,000 ($13,500,000 value less $6,555,000 loan payoff). Assuming you don't want to sell the property, you can refinance at 75% LTV again. 75% of $13.5 million is $10,125,000.

How much equity can you extract? Assuming a holdback of $1 million for capital improvements and mortgage payment reserves, the operator can extract about $2,570,000 ($10,125,000 new mortgage less $6,555,000 payoff old mortgage less $1 million holdback). This cash is returned to all of the investors or can be invested in a new project. Because it is refinancing of a debt, there is no tax on the refinance proceeds (at least up to the original principal return amount).

Note that this is a 100% (more or less) return of principal. By returning all of the principal to investors, the investor is left with no "I" (investment) in the "ROI" (return on investment) formula. Which means that you are dividing by zero...which effectively results in an infinite return.

Summary of tax breaks so far

So, continuing with this example...You've invested with a reputable Sponsor who has put together a single-purpose LLC to purchase a commercial real estate asset for $10 million. You confirmed the structure of the deal with your tax strategist, who liked the direct investment opportunity. You did your own analysis of the asset by reviewing the MSA and the submarket. Your Sponsor hired a great property manager and spent three years making marketing and operations upgrades which drove significant rent increases and improved occupancy. Costs have been held in check, and the property has thrown off a healthy average 7% annual cash-on-cash return for the past seven years. You've already received almost 50% of your original investment as a result of cash from operations.

So how much have you paid in taxes? The Sponsor is depreciating the appropriate percentage of the cost of the building and other improvements each year. Additionally, a cost segregation study allowed accountants to deduct dramatically more than the Net Operating Income of the property. Which is <u>your</u> NOI since you're a direct owner of this property. So far, for seven years, you've

received a passive loss on your tax return each year. Yet you've pocketed almost half of what you originally invested.

Now you get word that the Sponsor is refinancing the property, and you will receive virtually 100% of what you originally invested in one day. Also tax-free, since it was generated through refinancing a debt. **You've paid exactly zero in taxes**.

Wait, this sounds too good to be true. We'll have to pay the piper someday, right? Yep. That someday is the day the property is sold. Or is it?

Defer Taxes at Sale Through a 1031 Exchange

You may be familiar with the 1031 Exchange. This is an IRS sanctioned vehicle that allows you to effectively exchange one asset for another of "like kind." Capital gain taxes on the sale of the asset you are selling are not cancelled or avoided, but rather deferred until the sale of the second (or future non-exchanged) property at a later date. At the time of the "final" (non-exchanged) sale, all of the accrued gain for previously exchanged properties will be paid at once.

While it may sound better to you to pay it as you go, remember our taxed versus tax-free penny doubled daily example. It's virtually always much better to avoid taxes for as long as you can. It's easily provable and well documented.

So, what is this "like-kind" provision? Does that mean a 400-pad Cincinnati mobile home park must be traded for a 400-unit mobile home park in Cleveland? Not at all. The IRS regulations for real estate exchanges are actually very broad. The website I cited in the information box is very helpful here...

Both the relinquished property you sell and the replacement property you buy must meet certain requirements.

Both properties must be held for use in a trade or business or for investment. Property used primarily for personal use, like a primary residence or a second home or vacation home, does not qualify for like-kind exchange treatment.

Both properties must be similar enough to qualify as "like-kind." Like-kind property is property of the same nature, character or class. Quality or grade does not matter. Most real estate will be like-kind to other real estate. For example, real property that is improved with a residential rental house is like-kind to vacant land. One exception for real estate is that property within the United States is not like-kind to property outside of the United States. Also, improvements that are conveyed without land are not of like kind to land.

As a result of the tax reform changes in late 2017, real estate is now the only property type qualified for a 1031 exchange. Art, vehicles, patents, etc. are now disqualified. The law was derived from the possibility that properties could be swapped, and there would be no cash to pay taxes on the gain. But it was broadened to allow the sale of one property and the purchase of another within about six months, with the funds from the sale of the first property held by an intermediary. Again, from the IRS site…

What are the time limits to complete a Section 1031 Deferred Like-Kind Exchange? While a like-kind exchange does not have to be a simultaneous swap of properties, you must meet two time limits or the entire gain will be taxable. These limits cannot be extended for any circumstance or hardship except in the case of presidentially declared disasters.

The first limit is that you have 45 days from the date you sell the relinquished property to identify potential replacement properties. The identification must be in writing, signed by you and delivered to a person involved in the exchange like the seller of the replacement property or the qualified intermediary. However, notice to your attorney, real estate agent, accountant or similar persons acting as your agent is not sufficient.

Replacement properties must be clearly described in the written identification. In the case of real estate, this means a legal description, street address or distinguishable name. Follow the IRS guidelines for the maximum number and value of properties that can be identified.

The second limit is that the replacement property must be received and the exchange completed no later than 180 days after the sale of the exchanged property or the due date (with extensions) of the income tax return for the tax year in which the relinquished property was sold, whichever is earlier. The replacement property received must be substantially the same as property identified within the 45-day limit described above.

So, what does this mean to you as a commercial real estate investor? It could mean that you are able to sell ("exchange") your property and...after paying minimal taxes on your returns over a number of years...after paying no taxes on proceeds from a refinance...that you are able to defer the capital gains tax as well.

By the way, real estate investors feared we would lose our beloved 1031 exchange with the tax reform law of late 2017. The 1031 was discontinued for all kinds of personal property like vehicles and artwork and patents. But it was maintained for real estate. Which I believe was the original intent of the law anyway.

As a fund manager, I was concerned that our investors wouldn't be able to take advantage of the tax-deferred exchange offered through Section 1031. And that's true – it's very impractical for most funds. But there is the opportunity for another type of exchange called a 721 Exchange. This allows shareholders in one company to swap their shares to another and defer capital gains. This can be a great option for fund investors. And it can mean a restart of the capital gains clock in the new entity from what I understand.

Other Tax-Deferral Options

Though it is beyond the scope of this course, there are a few other very effective tax-deferral strategies that can be implemented instead of a 1031 Exchange. When I sold my company in 1997, we utilized one called the Charitable Remainder Trust. By donating your stock to a trust like this, you can avoid capital gains and still get the effective benefit of the income from future investments. The plan is that all of the assets will eventually be donated to charity.

There are at least three other alternatives to the 1031 Exchange that could allow you to defer capital gains taxes upon the sale of your property. Reply to this email with some general information about your property to see if one of these could be a fit for you.

Die and pay taxes?

Is it possible to completely avoid capital gains tax, too? If you have enjoyed the tax benefits of depreciating your property for a number of years...then performed a 1031 exchange at the time of sale...then perhaps another...you will likely be faced with a very small tax basis...and a very large taxable gain. Which is usually still better than paying taxes along the way.

If your estate is set up properly, however, it may be possible for your heirs to reset the basis of the assets at the time of their inheritance. Their assets could reflect the enormous growth possible from tax deferrals, and they could start with a clean slate: The opportunity to start depreciating these assets again from the beginning. (Note that there may be a cap on this.) Ask your CPA or tax strategist about the "step-up-in-basis" at the time of inheritance.

As the old saying goes, there are two things you can't avoid in this world: death and taxes. Some people dread the latter more than the former. Commercial real estate investing provides a wonderful opportunity to largely avoid this unpleasant aspect of life in this fallen world.

Do you see why I refer to commercial real estate as a great path to achieve multigenerational wealth?

Self-Directed Retirement Account Options

Another tax savings measure is to directly invest in commercial properties through a self-directed IRA or Solo 401(k). I have had a self-directed SEP IRA and a self-directed Roth IRA for almost two decades, and I only regret not doing this sooner. If you have a 401(k), SEP, or another tax-sheltering retirement plan on your own or through your employer, you can usually roll this into a self-directed IRA and sometimes into a Solo 401(k).

Self-directed IRAs can take the form of a Roth IRA, a SEP IRA or a Solo 401(k). The Roth IRA allows after-tax contributions, but gains are never taxed. SEP and Solo 401(k) plans allow pre-tax contributions, but they grow tax-free, and withdrawals are taxed (theoretically at a lower rate in the future).

While a traditional retirement plan had a small, fixed number of investment options, a self-directed IRA opens up a significant number of investment options. Though there are limitations on the type of investment and the way it is handled, the flexibility of this vehicle is almost "dangerous."
The Self-Directed retirement account is not for everyone…

- If you're a fan of the Social Security system, and you like the ROI you're getting on the 7.65% FICA (really 15.3%) investment you make from each paycheck, then the self-directed IRA is probably not for you. The IRA puts you in control of your own destiny.
- If you love to invest in the latest investment scheme or crazy invention your neighbor is working on in his basement, the self-directed IRA could get you in trouble. But at least you have the freedom to lose your money as you see fit.
- If you think your plan administrator can do a better job picking investment options (typically mutual funds or bond funds) for you, then you don't need the flexibility offered by the self-directed product. There are easier and cheaper ways to accomplish your investment goals. (Honestly, many people would be far better off with this option. Especially those in the second category above.)

But if you have come to a place where you have the knowledge and desire to safely invest in commercial real estate, and you want to use your retirement account to do it, then a self-directed retirement plan is the only option I am aware of.

There are many great administrators available, and they will handle the paperwork on every transaction for you to be sure you remain in compliance. They will also handle your annual returns and help you with income from the vehicle when it's time to receive it. I use a full-service firm that provides a diverse menu of services and options, but they are more costly than some discount services that allow you to do most of the work on your own. For my current self-directed IRA administrator recommendation, just respond to this email.

Avoid Passive Loss Limitations

As we have discussed, commercial real estate provides unique opportunities to earn a significant passive income while simultaneously receiving losses on your tax return. These losses are limited to $25,000 per year in some cases (they may be carried forward though) and may be limited further by your income if you're an active investor. Passive investors should be able to bank and carry forward passive losses with no limit on time or amount.

If you spend most of your professional time in the world of real estate, and if you work more than 750 hours per year, there may be a way for you to deduct much more by qualifying as a Real Estate Professional according to IRS guidelines. There are so many qualifiers to this process that I don't want to develop this idea any further here. I just wanted you to know it is possible. Talk to your CPA or tax strategist to learn more.

What About Tax Reform?

Of course, everyone wondered about the impact of the late 2017 tax reform bill. First, as mentioned above, real estate investors thought we might lose the 1031 tax-deferred exchange. That didn't happen. Then, after the regulations were published, it took the IRS over a year to interpret them. When they did, we had a lot to be grateful for. Love him or hate him, real estate investors are getting a lot of benefits from the Commercial Real Estate Investor in Chief in the White House – and Congress.

As a result of the tax reform bill, experts are noting that high net worth investors are more focused than ever on the commercial real estate sector. Here is a quick overview:

1. High net worth investors receive a 20% deduction on income from pass-through business entities. This applies to active ownership via partnership, LLCs, and investors in public and private real estate funds.
2. Taxpayers can factor in 2.5% of the original purchase price of commercial real estate assets as part of their 20% deduction. The combined effect of these first two benefits could create a 25% tax reduction (10 points – from a 39.6% to 29.6% rate).
3. Section 179 of the tax code has long allowed limited deductions for capital improvements in the current tax year. The new law expands this allowance significantly, which could result in significant paper losses for some capital improvements. For example, a new roof or HVAC system, which would have been depreciated over many years before, can possibly be fully deducted in the current year under the new law.

The impact of the new law was felt immediately upon passage. A post in the National Real Estate Investor told the tale: In November of 2017, a month before tax reform, only 26% of NREI readers

believed the market would continue to expand. Just two months later, that number jumped to 41%, which is over a 50% jump (15% increase ÷ 26% original = 57% increase). And their survey showed that the number of respondents who believe the market had peaked dropped from 59% to 45%.

We don't depend only on investor sentiment; we depend on careful analysis using real numbers. But let's face it… sentiment and widespread beliefs will drive behavior. And this will impact cap rate. And it may impact your ability to get a good deal for now. And that could also result in your getting a screaming deal someday (from a bank foreclosure) if you're patient.

This was a lesson on taxes. But I just wanted to add this warning, and this ray of hope. Taxes impact behavior. And there's never been a better time (that I can recall) to be a commercial real estate investor. The benefits I outlined in the previous lessons paint this picture clearly. The taxes are just the cherry on the sundae. But oh, what a tasty cherry!

Lesson 4: Why I Invest in Recession-Resistant Commercial Real Estate

I don't know when you'll read this. But as I'm writing it, the international headlines are frightening. Well, at least for many investors...

The Next Recession Will Destroy Millennials

Is a Global Recession Coming? Here are Seven Warning Signs

New Recession Warning: The Rich Aren't Spending

Homebuyers Are Bracing for a Recession: Study

That first article, from *The Atlantic*, states:

"The trade war is dragging on. The yield curve is inverting. Investors are fleeing to safety. Global growth is slowing. The stock market is dipping. The Millennials are screwed."

My firm even put the brakes on multifamily acquisitions.

Howard Marks and Warren Buffett have been influencing our thinking. A lot. Marks and Buffett hoarded cash prior to the 2008 downturn and they both "caught a falling knife" by buying up lots of financial equities as the market was a in a free-fall.

They each made billions from that recession.

And Buffett has been criticized at his last two annual meetings for hoarding cash. Hmmm.

I recently read Howard Marks's excellent treatise on market cycles: Mastering the Market Cycle: Getting the Odds on Your Side.

So why am I sleeping so well at night amidst these rising recession fears? And why is my firm raising more money than ever to invest in commercial real estate?

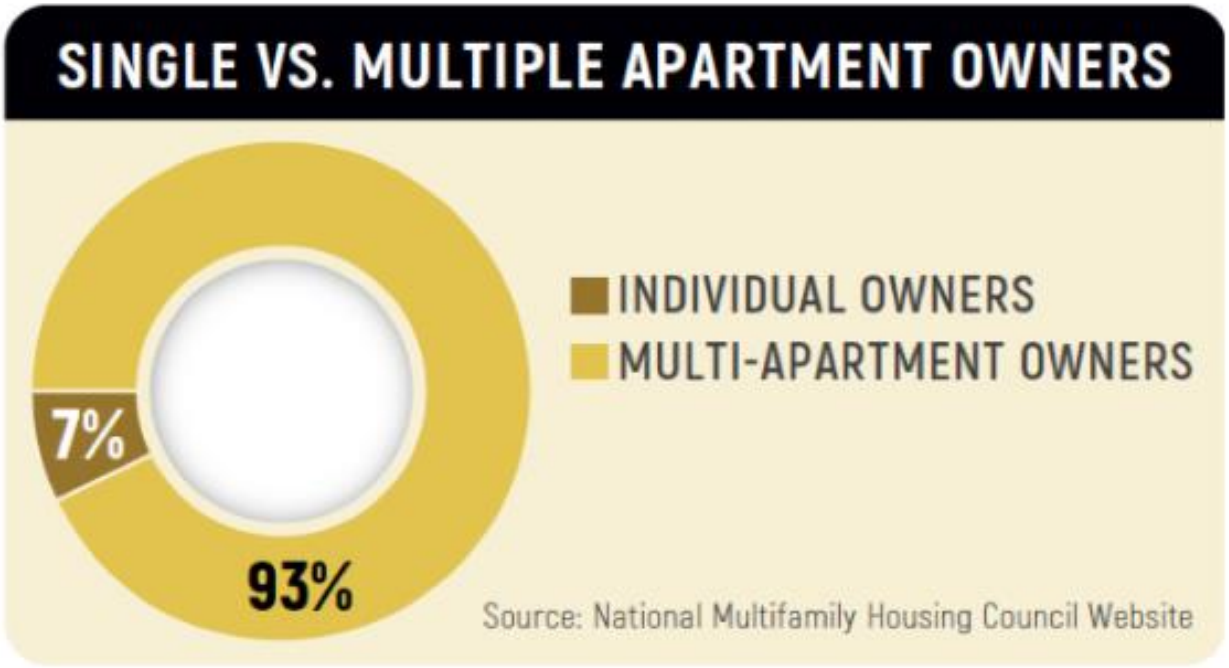
The Joy of Frag/men/ta/tion

About 93% of multifamily properties above 50 units are owned by companies with multiple assets. This doesn't mean they're all well-run. But it means that, in general, the operators have wrung most of the value out of them.

Value-add opportunities in multifamily are few and far between these days. It's very hard to find a well-located, mom-and-pop-run apartment complex with lots of upgrade opportunities. Which means they're being acquired with very little margin of safety, a risky proposition at this point in the cycle.

Buffett would probably be selling apartments right now (if he owned them). Multi-billionaire Sam Zell unloaded over 23,000 of his apartment units a few years back. Investors beware!

By the way, Zell is the largest owner of mobile home parks in the nation, with an estimated 150,000 pad sites. Last year, Zell paid a whopping $50.35 Million for a single park in the Everglades. The 100-acre park has 612 pad sites, so that breaks down to $82,271 per pad. This park was originally purchased by the seller for $1.6 Million in 1971. Do you think Zell knows something that many of us missed?



Contrast Apartments with Mobile Home Park Ownership

It is estimated that there are about 44,000 mobile home parks in the U.S. It's also estimated that about 90% of these mobile home parks are owned by mom-and-pop operators.

It's a highly fragmented ownership base, and this is a big deal for you and me as potential investors in this asset class.

This means that a typical mobile home park owner doesn't have the knowledge, or the desire, or the resources to increase income and maximize value.

They really don't need to.

After all, many of these owners have owned these parks for a generation. Or more. They live there. (Or they live at the beach.) They know the tenants. Their goal is to minimize hassle and keep collecting checks. They are (often) debt-free, and their costs are minimal.

Many of them are ready to sell and move on.

This could be your opportunity.

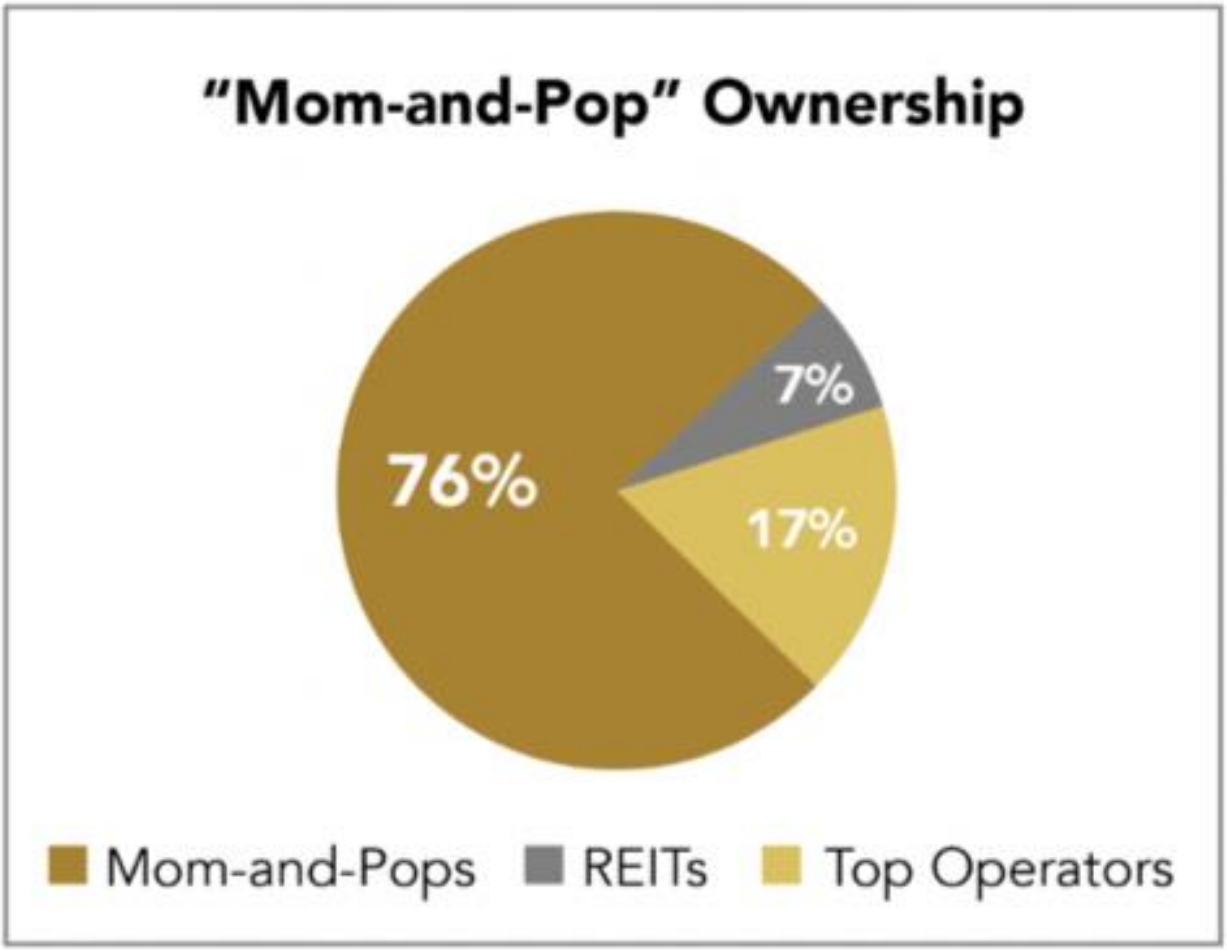
If you – alone or through an investment partnership – can acquire a well-located mobile home park like this... at a fair price... you may have the opportunity to transform it into a well-run, profit-

churning, value-maximizing ROI machine.

How Does Self-Storage Stack up against Multifamily Ownership?

There are about 53,000 self-storage facilities in the U.S. That's about the same as all of the McDonald's, Starbucks, and Subway restaurants in the country.

It's estimated that about 76% of these self-storage facilities are owned by independent operators. Many of these are mom-and-pop owners. And many are in the path of progress.



Source: 2017 Self-Storage Almanac

Most of these mom-and-pops don't have the desire, knowledge, or resources to upgrade their facility to maximize profits and increase the value. They often don't have to.

Many self-storage facilities have followed Kevin Costner in *Field of Dreams*, believing that "If I build it, they will come." And for years customers did come.

Self-storage operators didn't need a website.

Or an office.

Or lighting.

Or security.

Or fencing.

Some operators told clients they would never get a rate hike – no matter how long they stayed. Others told their tenants they could shove their cash or check payments under the door of their storage unit, and they'd pick it up. Many don't even accept credit cards or online payments...to this day.

And many have vacant land or parking areas where more climate-controlled storage could be constructed by a professional operator.

There's so much more I could say but suffice it to state that buying a well-located mom-and-pop mobile home park or self-storage facility with meat on the bones can be part of the recipe for great success.

> Not all commercial real estate is created equal. It has not been a great time to invest in retail in general, for example. Store closures in 2019 total over 12,000. But reports show that another 75,000 stores could be shuttered by 2026.

Buffett's Margin of Safety

Buying the right asset from a mom-and-pop is like buying a stock with a margin of safety. Warren Buffett would be proud of you for this.

The significant meat on the bones left by independent operators provides a wonderful opportunity to upgrade operations, improve net operating income, and drive surprisingly high equity growth.

Commercial real estate is the breeding ground to force appreciation and, with safe leverage, to catapult value. I spoke about this in a recent BiggerPockets video and gave three powerful examples on how this is done. (I admit it felt weird to talk about turning $100k into over $4 Million investing passively, but math is just math, and I built multiple margins of safety into this model as you will see in the video.)

So What About This Looming Recession?

Buying self-storage and mobile home park assets with a margin of safety is the first protection against a potential downturn that may be on the horizon.

But how did these asset classes perform during the last recession?

Years ago, a financial planner told me that planners and investors were always looking for an investment that did well in good times and continued to do well in bad times. He said that untold millions or billions of dollars would quickly flood an asset class like that.

When my company, Wellings Capital, set up our funds, we were searching for asset classes that thrived...or remained generally stable...through the last recession. In this order, we landed on

1. Mobile Home Parks
2. Self-Storage
3. Multifamily

Here's the logic in summary...

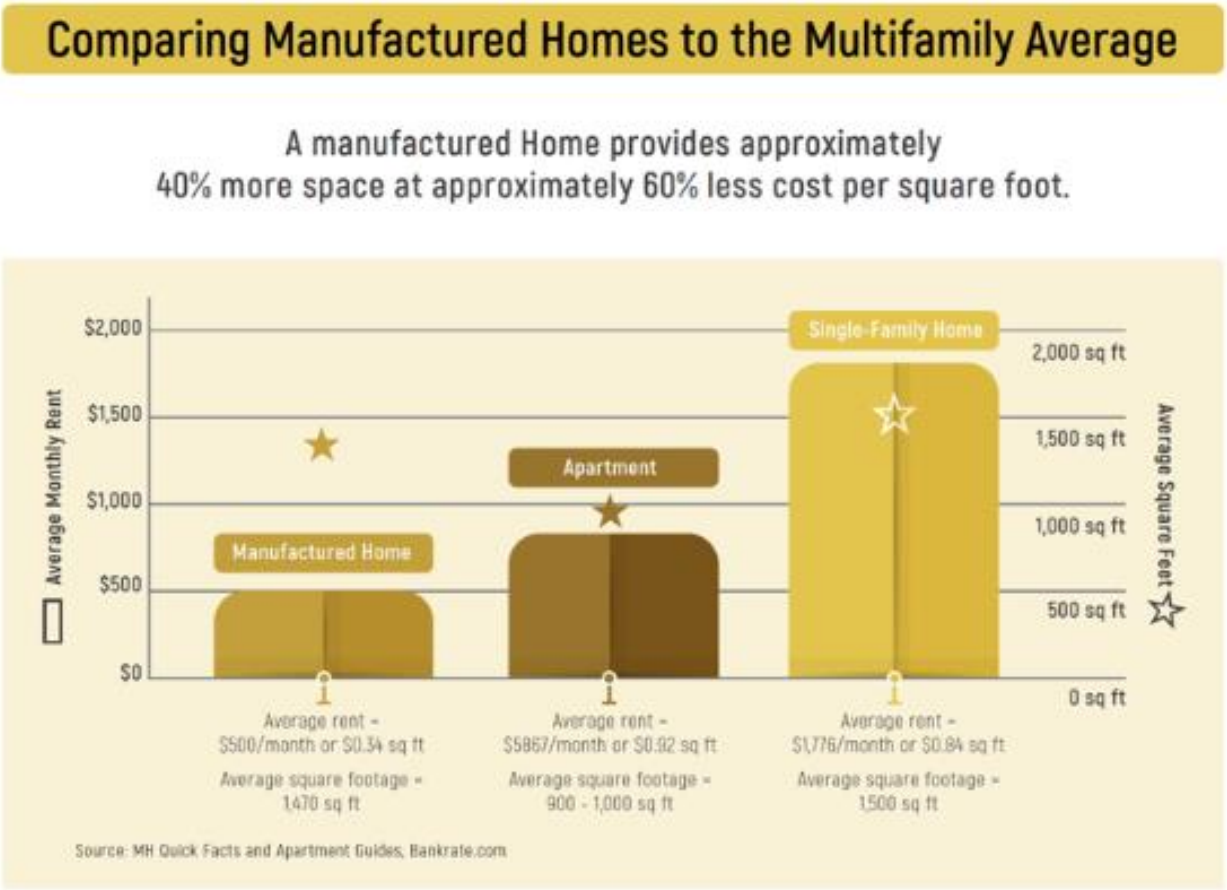
Mobile Home Parks in a Recession

There is a massive need for affordable housing. Ten-thousand people turn 65 each day. Over half have $10,000 or less saved for retirement. Millennials and others are in a lot of debt and wages aren't keeping up with the cost of housing. There is an affordable housing crisis.

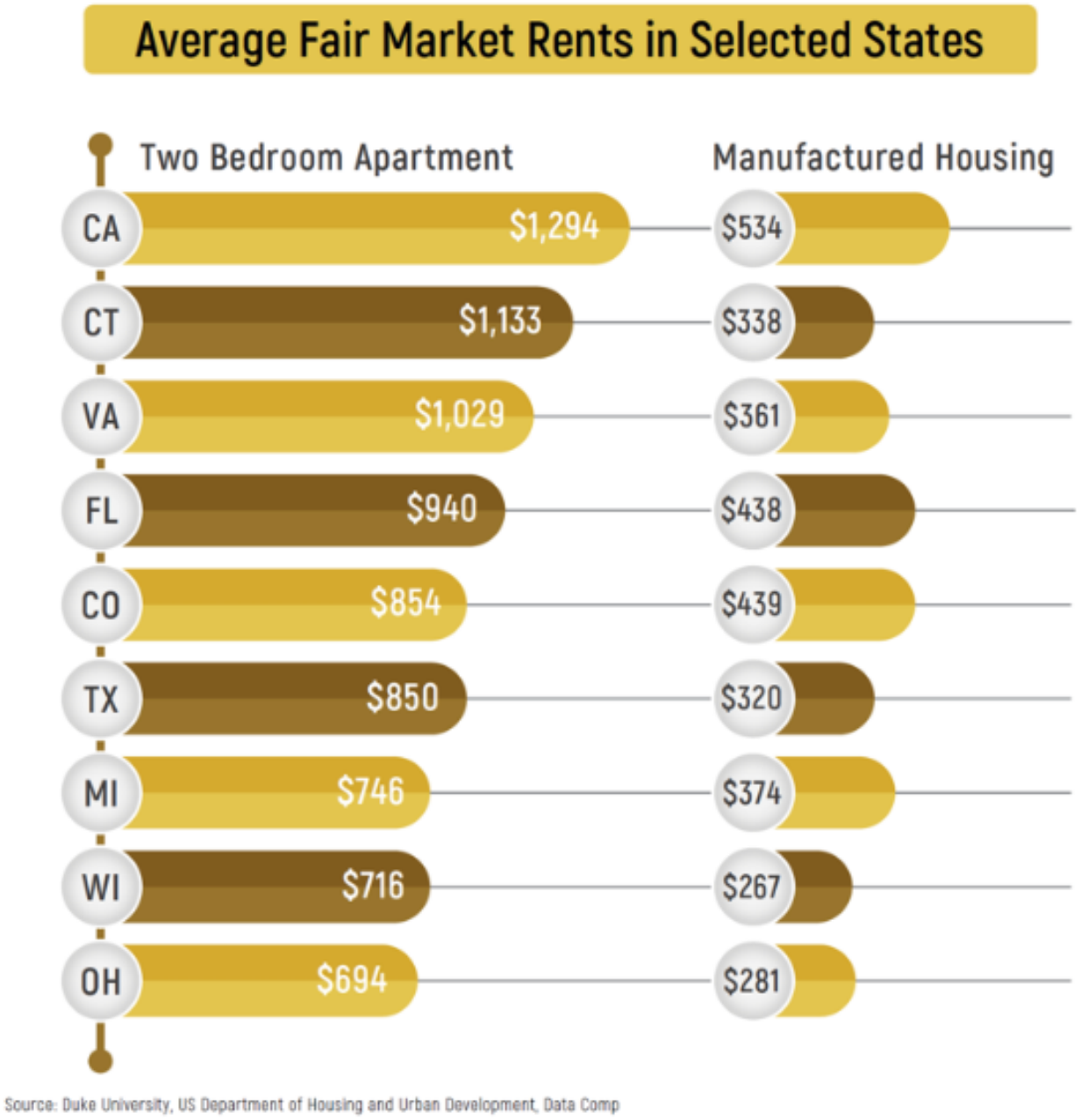
Mobile home parks are the only asset class with a shrinking supply and an increasing demand. One hundred or so mobile home parks are eliminated in the US every year. And only ten or twenty new ones are built, typically in out-of-the-way locations.

Mobile home parks are the lowest rung on the housing ladder. In a recession, when people lose their homes, they often rent a home or apartment. When home or apartment dwellers lose their homes, they may end up in a mobile home. Those who can't afford lot rent may end up under a bridge.

Check out these graphics comparing the size and price of manufactured housing to apartments and single family.



Notice below that the cost of an apartment is over three times as high as lot rent in certain markets. And this is for a two-bedroom apartment. A typical mobile home has three bedrooms.



Self-Storage in a Recession

Self-storage, as an industry, like mobile home parks, is largely recession resistant.

In good times...

Consumers are filling up their carts at Amazon and Walmart. They need a place to store their stuff.

In bad times...

Homeowners lose their homes. The downsize to apartments. Apartment-dwellers downsize to

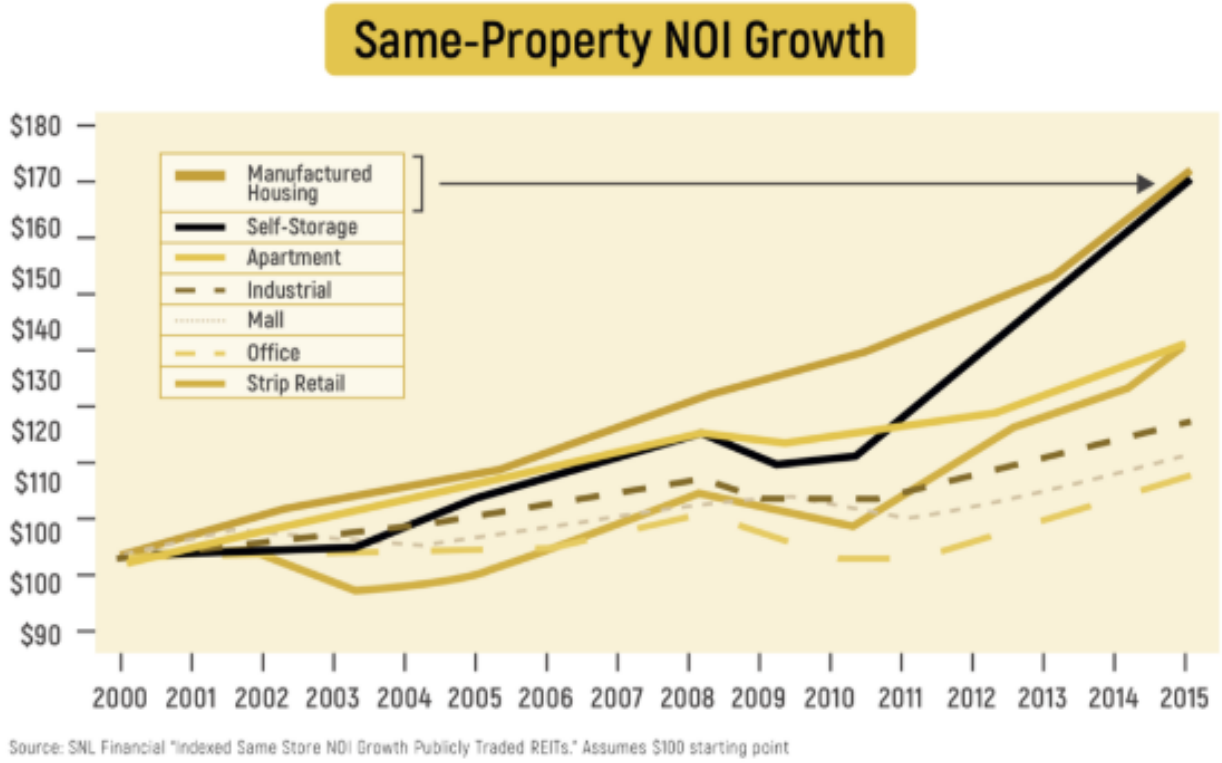
smaller apartments. Or to mobile homes. For a relatively small amount of money, they can store their stuff at a self-storage facility. They would often rather store it than give it up.

Self-storage tenants are inherently sticky as well. They typically don't leave over normal rent increases. (Neither do mobile home park tenants.)

Check out this graph showing same property growth of Net Operating Income growth by property for various asset classes. The first thing that might jump out at you is the fact that manufactured housing (mobile home parks) and self-storage lead the whole group. That's great. But there's something else that is more important to me.

Check out the dip in manufactured housing during the recession. *There is no dip*. Mobile home parks are inherently recession resistant. And you can think about why.

Admittedly, self-storage had a dip in 2008. It took off since then and climbed at the fastest rate of any asset class. Speaking of which, did you notice how mild the dip in the apartment sector was? The dip was short and corrected quickly.



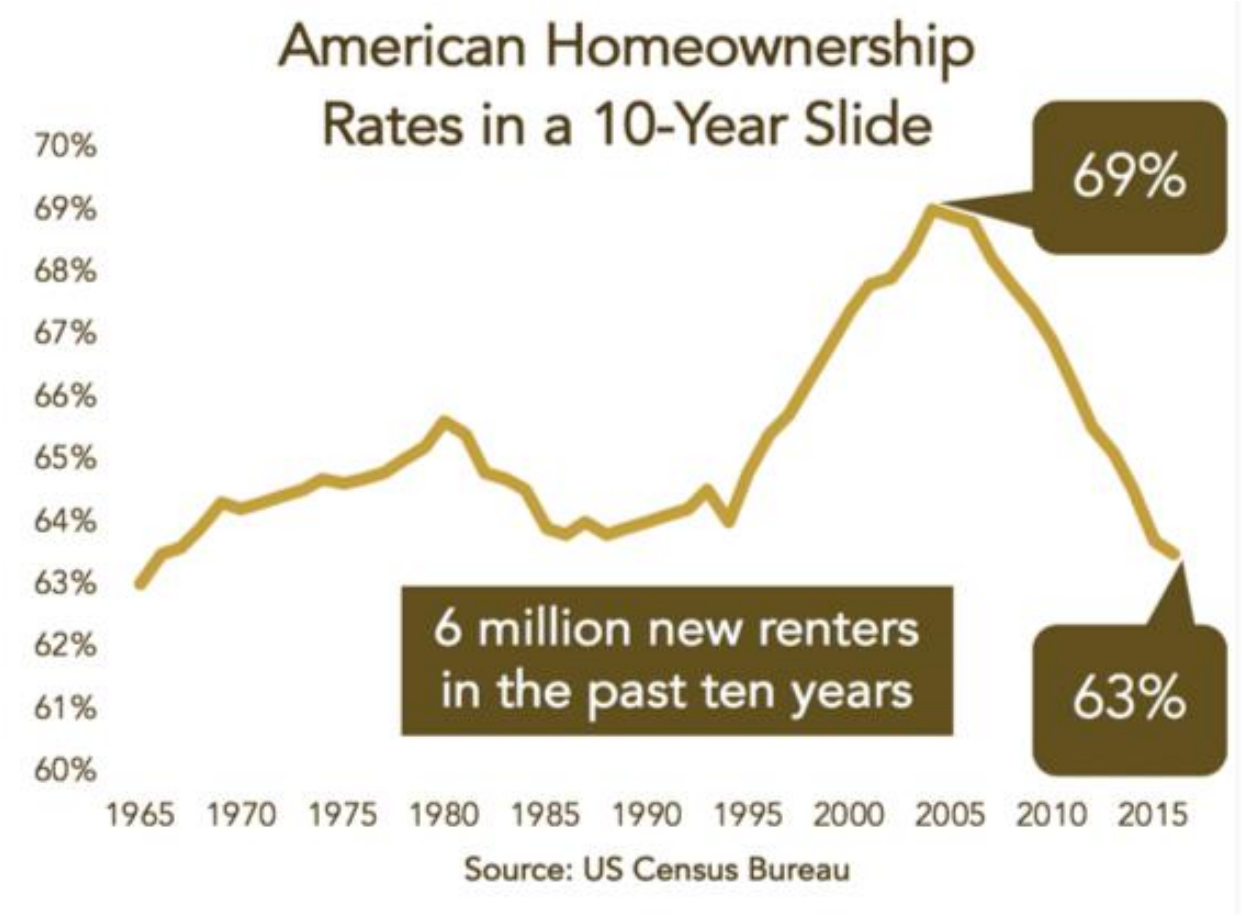
Multifamily in the Recession

Americans used to believe that their home was their greatest investment. The crown of the American Dream. Since the last recession, they don't believe that anymore.

Home ownership was artificially inflated from about 64% to 69.2% from 1995 to 2005. Government tampering was a culprit. They decided anyone who could fog a mirror should own a home.

Home ownership dropped from that level to its general historical norm of 63% in the next decade.

Boomers, Millennials, Immigrants and now Gen Z'ers prefer apartments over homes at a rate that has increased dramatically over past decades. Check it out...

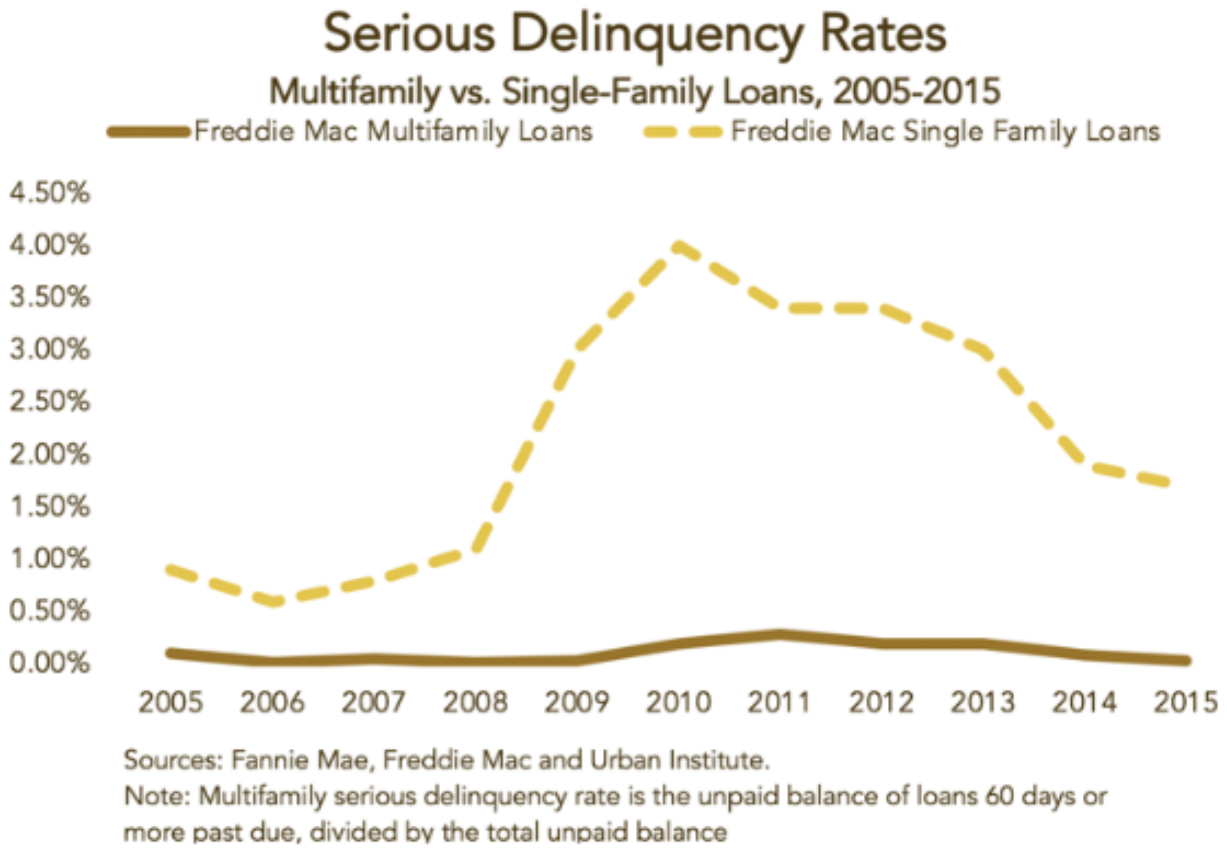


This is a long-term trend but note that the turning point...from high homeownership to a move toward renting...came during the recession. And this supply and demand inequity was exacerbated by the fact that little new construction was happening during the recession.

So What About Debt?

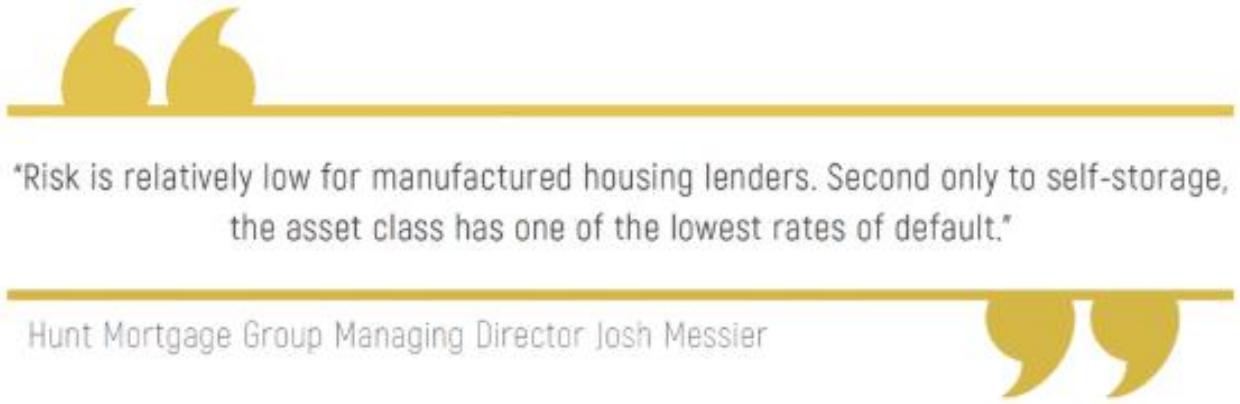
Debt causes one of the greatest risks for any investor during a downturn. We all know that home foreclosures skyrocketed during the last recession. In local and regional banks, the rates were reportedly as high as 10%.

The chart below shows serious delinquency rates for Freddie Mac single family versus multifamily. At the height of the recession, delinquency rates for multifamily were about 0.4%, which was only 10% of the single-family level. Since then the multifamily delinquency rate has dropped to only about 2% of the current single-family level.



So what about self-storage and mobile home park debt?

Though I don't have a graph for it, I have this quote from a lending authority:



Conclusion

Recession? What recession?

Every economy goes through cycles. That will never change. This one is no different. As of 2019, our country has experienced the longest recorded economic expansion in US history.

We are due for a recession.

A recession is not the time to sell. It's the time to wisely look for great deals and to acquire them. If a recession hits hard, there will be amazing deals in all types of asset classes. But in my mind, a smart investor will increase their odds for success by acquiring assets that...

- are already recession-resistant
- have a great margin of safety
- have historically low default rates
- and have operational meat on the bone

I would argue that mobile home parks, self-storage, and (to a lesser degree) multifamily fit that bill perfectly.

So why do I invest in these types of assets?

The answer is self-evident. Like my friend, the financial planner, said, if someone could locate an asset that performs well in an up or down economy, he should certainly invest in that asset class.

Lesson 5: The Importance of Betting on the Right Jockey

In the last four eCourse lessons, we've discussed:

1. The nature of true wealth. True wealth = Assets that Produce Income.
2. The commercial real estate value formula. Value = Net Operating Income ÷ Cap Rate.
3. The surprising tax benefits of investing in commercial real estate.
4. Why I recommend investing in recession-resistant assets.

Yesterday we discussed the *what*. Today we're going to discuss the *how*.

Here's my general proposition for investing in commercial real estate assets:

Don't try this at home.

What I mean by this is that this is a big-time game. It's not something to launch into lightly. Not something for a novice, or something to wade into casually. Or without an experienced team.

When Wellings Capital decided to expand outside of commercial multifamily, we thoroughly researched self-storage and mobile home parks. And we concluded that these asset classes were a perfect fit for our investors (as I mentioned yesterday).

Though we do real estate full-time, and have the resources to pull this off, we also realized that we don't have a cohesive, professional team with a track record in self-storage and mobile home parks since before the last recession. Yet that is the type of operator that I would want to invest with.

As a result, we began a nationwide search for best-in-class operators in these asset classes.

Operators who:

- are true experts in their field
- survived or even thrived through the last recession
- have professional standards, procedures, and controls in place
- have a cohesive internal team with defined roles and great experience
- will offer Wellings Capital (and thus our investors) a premium for making a large investment

We are betting on the right jockeys. And trusting them to pick and train horses who are winners. We couldn't possibly pull this off on our own and we don't think you can either. But you and we can benefit from their efforts.

John D. Rockefeller was perhaps the wealthiest man in American history. He figured this out over a century ago. He said...

And the most successful investor of all time operates the same way. Warren Buffett doesn't make widgets and he didn't create an insurance company. He doesn't bottle Coca Cola and he didn't choose Dairy Queen's flavors. He doesn't build manufactured homes in factories and he didn't design the mortgage products utilized by thousands of mobile homeowners.

But he profits from all these things in a big way. And Berkshire Hathaway's investors share in the wealth.

This is the model utilized by Wellings Capital. And investors in our funds are sharing the wealth. And saving on taxes along the way.

You'll Never Get Your Hands-on Assets Like These (but you could profit from them anyway)

I talk to dozens of real estate investors every month. One of the common themes is their inability to get deals these days. They're spending an enormous amount of time chasing deals of all shapes and sizes...and usually coming up empty.

And when they do get an opportunity, it's usually overpriced. Or they're outbid.

Like I said, this is not a game that can be played part time. In this market, you won't succeed by looking for deals on lunch breaks, evenings, and weekends. Many large operators have more cash than deals, and some of them don't know how to fix this problem. Except through overpaying. (Please don't invest in a deal like this!) Warren Buffett says the secret to success is saying "no".

The best operators and investors don't overpay. Some others do. Many will pay a stiff price for their actions. It's a seller's market out there, and it's tough for any of you trying to find deals.

Well, almost all of you.

There are a handful of professional operators who have refined the art of the acquisition pipeline. And they're getting an unfair advantage over the rest. These are the operators we're investing with.

Are you a weekend warrior? Are you spending your evenings and weekends and holidays and vacations spinning your wheels looking for a house to flip? Or a duplex? Or a mobile home park or self-storage facility?

I spoke to an investor in Washington State this morning. He told me he recently spent 300 to 400 hours looking for an investment property. He ended up acquiring a triplex. And it's apparently not that profitable.

How much free time do you have per day? Five hours tops? This investor just chewed up about **70 days** of free time. To get what sounds like a marginal investment.

It's hard to go up against professionals. And the masses of amateurs who are driving up prices.

Going up against the pros is like options-trading in your spare time. It can be a zero-sum gain and you're playing against corporations with billions of dollars in Ivy League grads and machines. Though you can make good money, you probably will not win in the long-term.

Some operators are just getting the upper hand over the rest.

My friend and operating partner, Matt, is one of those guys. Matt has a team of four guys working the phones full-time. Eight hours a day, five days a week. Their sole purpose is to find deals.

They dial the numbers of thousands of mom-and-pop self-storage and mobile home park operators every week. They take notes. They follow up.

Week in and week out.

Month in and month out.

Year in and year out.

By being there, being consistent, being empathetic, and being skilled, they are able to find multiple deals every month. Opportunities that other operators and brokers won't get a shot at.

Case in point...

Matt contacted the 88-year old owner/operator of a Michigan mobile home community ***over seven years ago***. He wasn't interested in selling. But Matt stayed in touch every few months for the last seven years.

Matt's phone rang two days ago. It was the niece of the now 95-year old park owner. She said that he was done. He could no longer operate the park. She went on...

Niece: "Is your offer from 2017 still on the table?"

Matt: "Uh, yes. Is that price workable for you?" (Prices have climbed a lot since 2017)

Niece: "Yes. Let's get a contract signed."

When I spoke to Matt yesterday, he was already on the ground in Michigan.

My friends, deals like these are not for casual seekers. Deals like these are the spoils rewarding those with a plan. Those with a well-established team. Those who follow up consistently. Those who speak to mom-and-pop sellers with empathy and skill.

You and I don't have to have a team like Matt's to benefit from their diligent efforts. We can get access to the fruits of their labors from the comfort of our own homes. And we can enjoy the tax benefits of direct ownership in recession-resistant commercial real estate assets like these.

As we wind down this eCourse on the joys and profit of commercial real estate investing, you are faced with a few decisions:

1. Do you see the great benefits to growing your wealth through commercial real estate?
2. If so, are you going to try to go it alone? Or are you going to go passive and trust an experienced operator to vet deals and provide superior tax-advantaged results?
3. Do you want to entrust your capital to a single operator and deal, in a single location? Or do you want to diversify?

(I know these questions sound self-serving. But this is what we truly believe is the best path for superior investment results with the lowest possible risk. This is how we invest ourselves!)

You may love real estate investing and resist the thought of going passive. Yes, I agree that passive investors don't get the thrill of the chase. But passive real estate investors also don't get...

- the massive time commitment involved with real estate investing
- the massive debt in their name
- the 3 AM calls dealing with toilets, tenants, and trash
- hundreds of other challenges that often consume nights, weekends, and vacations

And while there are no guarantees, passive investors who select a ***carefully vetted operator*** often get access to better returns and equity growth. With all of the same tax advantages. If you are planning to invest with a sponsor/operator, please take your time and do the due diligence.

Before this went to press, Matt called me again and told me he got another off-market deal. This one is in Minnesota. In a similar way to the other deal, he had been staying in touch with the owner.

The owner had a dispute with his partner and there is potential litigation. The guy knew just who to call when things went south.

This 300+ unit self-storage facility is only 70% occupied and in need of some TLC. This is the perfect situation for Matt to step into. His plan is to bring occupancy to 90% and do the deferred maintenance. This will significantly increase net operating income, value, and accelerate investors'

equity.

Matt's passive investors enjoy the returns of his labors. He's actually given investors over 60% IRRs for the past few years, a number that was independently verified by a ratings firm. My wife and I are among his investors and my firm and our investors are investing heavily with Matt. We spent a lot of time and effort vetting Matt upfront. But now the hard work is in Matt's court. And he does it very well.

Buying from a mom-and-pop and upgrading to REIT standards is a powerful operational strategy.

But it won't last forever.

The last WWI veteran died a number of years ago, and there are no more on the planet. In the same way, mom-and-pop owned assets are being gobbled up and eventually this strategy won't be in play.

We are excited to be part of making hay while the sun shines. It's shining on passive commercial real estate investors right now. Is it shining on you?

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As we wrap up this five-part eCourse, I'm going to issue a three-fold challenge.

1. I challenge you to find a better tax-advantaged, high-yield, lower risk investment than commercial real estate. Remember this graph from Lesson #2:

2. I challenge you to find investments more recession-resistant than mobile home parks and commercial self-storage. Remember this quote from Lesson #4:

"Risk is relatively low for manufactured housing lenders. Second only to self-storage, the asset class has one of the lowest rates of default."

Hunt Mortgage Group Managing Director Josh Messier

3. I challenge you to try to get risk-adjusted, tax-advantaged returns by plunging into these waters alone. Some people can do it alone, and that's great. But I think you'll be hard-pressed to do this. Remember Rockefeller's quote and Buffett's strategy above. This is a team sport. I invest this way and I recommend that you consider this strategy as well.

Happy Investing!

Paul Moore, Managing Partner