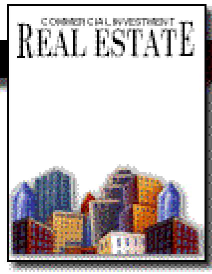

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Group Dynamics

Syndication Trends Reveal That More Investors Are Pooling Their Money.

by Eugene A. Trowbridge, CCIM, MAI

Sponsoring syndications offers commercial real estate professionals investment opportunities greater than those they may be able to handle individually. Syndicators pool the resources of several investors to acquire a more expensive property, while diversifying the risk of real estate ownership. As an added benefit, sponsors maintain control of properties that otherwise could not be controlled through contractual agreements with buyers or sellers.

While cash is the most likely resource to be pooled, experience and the ability to obtain financing also are needed to make investments profitable. Individually, a money resource, a developer, or a landowner may not be able to facilitate a project, whereas a simple joint venture may be all that is needed to see it through to completion. This is where the syndicator’s expertise is critical.

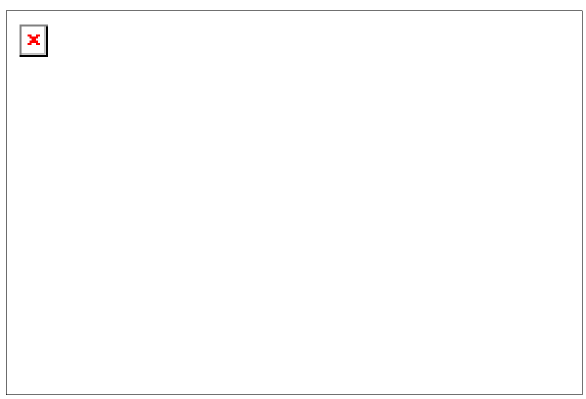
While many syndicators are well-schooled in the aspects of commercial investment real estate analysis and acquisition, few possess the necessary management skills. As opposed to a simple brokerage transaction, syndication is a long-term commitment. The amount of continuing communication between syndicators and investors, such as quarterly and annual reports, can be overwhelming. Few transactional agents are trained for this type of group communication and management.

In response to high interest in syndication, an informal survey of CCIM Institute members regarding their involvement with group investments was conducted in 1996 through a broadcast fax to all of the institute’s designees. This survey was repeated in 1999 with another broadcast fax and again in 2001 through a broadcast e-mail. The results indicate how syndications have changed over the years, including emerging syndication trends and potential problems to avoid.

Syndication Structure Trends

The number of investors in typical syndications has decreased over the years: 83 percent of the 2001 respondents used 10 or fewer investors, compared to 1996, when 75 percent of syndications had 10 or fewer investors.

On the other hand, the amount of equity being raised is increasing. In 1996, 60 percent of sponsors planned to raise $1 million or less, and only 2 percent raised between $5.1 million and $10 million. In 2001, only 38 percent raised less than $1 million, but 42 percent raised between $1 million and $5 million. In last year’s results, 15 percent of syndicators said they raised between $5.1 million and $10 million.



Syndicators are becoming more aggressive in raising funds from each potential investor, and the minimum required investment is approaching $50,000. In 2001, 49 percent of the survey respondents had minimum investment requirements of more than $50,000 and another 34 percent required between $25,001 and $50,000. In contrast, in 1996, only 27 percent of syndicators required more than $50,000 as a minimum investment, and 58 percent accepted minimum investments from $25,001 to $50,000.

Just as with individual real estate investors, property types favored for syndications have changed depending on the market cycle. During the past six years, retail, multifamily, and industrial properties have been listed as the top choices. Other popular property choices were self-storage, hospitality, and raw land. Gambling casinos in Mexico City and an automobile dealership were the most unusual properties cited.

Common Organizational Structure

Prior to the Tax Reform Act of 1986, the limited partnership was the legal entity most often used in real estate syndications. Most LPs were created to allow private securities offerings to small groups of investors through local securities firms and financial planners. Master limited partnerships were created to allow public securities offerings to large numbers of investors through Wall Street.

Investors favored LPs because they could invest in real estate with limited liability: They knew the maximum loss exposure they would have during the life of the partnership. In addition, investors would receive the tax losses from the investment to use on their own tax returns, and the partnership itself was not taxed.

Syndicators liked the LP because it gave them, the general partners, total control over the decisions made during the investment. In return for total control, sponsors faced unlimited liability in the event of any losses suffered by the partnership.

However, with the economic downturn in the late 1980s and the enactment of the Tax Reform Act, many properties ran into financial problems. Investors found themselves unable to solve problems because they were not allowed to directly manage the investments, and sponsors found their personal liabilities overwhelming. Sponsors became unwilling to form new syndications, and investors were not willing to invest in new LPs.

The industry needed a new legal entity to free sponsors from unlimited liability and give investors the ability to take an active role in management but not lose the benefit of limited liability. In 1988, the federal government recognized the limited liability company structure, and by 1996 all states had approved some version of it.

In the 2001 CCIM survey, 77 percent of the respondents said they were using the LLC as the legal entity in their syndications. Today, LPs for the most part have disappeared. Tenancy-in-common arrangements retain their popularity as some investors look to a vehicle in which they can take advantage of the capital gains tax deferral offered through Internal Revenue Code Section 1031.

Most syndications are structured as private offerings: They generally have 10 or fewer investors and the equity raised is less than $5 million. Under federal securities laws, meeting these requirements prevents offerings from being classified as public. By using private offerings, sponsors avoid the expense and regulation required in a full securities registration.

According to the survey, organizational fees paid by the sponsors continued to range between 1.5 percent and 4 percent of the equity raised. Organizational fees include legal, accounting, printing, and underwriting costs paid to facilitate the syndication’s formation. Small offerings usually have organizational fees in the upper end of the percentage range, but a smaller absolute dollar amount.

Larger offerings will show a greater dollar amount, but a lower percentage. Sponsors should research the estimated amount of these fees before determining the amount of equity to be raised.

Sponsor Compensation

One of the primary reasons commercial real estate professionals sponsor syndications is the potential for profit. However, no law dictates the fee-splitting arrangement between the sponsor and the investors in private offerings, and there are as many different arrangements as there are syndications.

The surveys asked only about the share of profits on a transaction that sponsors expected to realize. Sponsors can look to the profits they expect to receive in return for taking the risk and responsibility of forming and managing syndications. In 2001, the results showed that sponsors expected to receive 17 percent of the profits, which is a reduction from the 25 percent sponsors expected to receive in 1996.

Brokerage, leasing, property management, and financing fees are paid on every transaction, regardless of whether or not a syndication is formed to own the property. Sponsors should not include these fees in measuring the benefits they expect to receive.

Learning From Past Mistakes

The surveys asked respondents to list the mistakes they had made in past syndications. Most of the results fell into three broad categories.

Too Much Risk for Too Few Rewards. There is often more risk in real estate investments than anticipated. This problem is even greater for a syndication's sponsor, who may take on the risks of ownership for all the group members. The mistake most often mentioned is that sponsors assumed too much personal liability in return for the amount they expected to receive in profits.

The rise in the use of the LLC as the legal entity in syndications directly addresses part of this problem. In an LLC, every member, even the sponsor, benefits from the limited liability feature. But that is only half of the mistake. What about the amount of profits the sponsor expects to receive?

Over the six-year span the surveys were conducted, a trend appears to have developed in the wrong direction.

As reported, the percent of profits sponsors are anticipating has *decreased* from 25 percent to 17 percent. Is this a result of sponsors taking on projects with slimmer anticipated total profits? Or, is this the result of marketing pressure, where sponsors find they must reduce their profits to compete for the available cash from investors?

Whatever the cause, sponsors should examine carefully their expected profits before taking on a syndication. By using parternship modeling software, syndicators can calculate the present value of the anticipated profits at a discount rate adjust- ed for an appropriate level of risk, and the sponsor can determine whether the expected benefits outweigh the expected risk. In certain projects, the best decision may be to collect traditional brokerage fees in a transaction and leave the syndication to someone else.

Too Many Investors. Comments like “No whiny investors,” “Did not maintain control,” and “Make sure I like and trust my partners,” all point to the difficulty in managing the group, not just the property. Many sponsors have found that the care and maintenance of investors is something they are not prepared to handle.

Sponsors have dealt with this problem in two ways. First, they have lowered the number of investors in each group. As a result of these smaller groups, each investor is required to make a larger minimum investment, and the feeling of many sponsors is that sophisticated investors who are able to contribute more money are better able to absorb the risks associated with a real estate investment. Second, the use of the LLC entity almost demands a smaller number of investors so each investor can have an active role in management. Too many investors make the decision process cumbersome.

No Confidence in Income Tax Laws and the Market. The third most-frequent comment addresses the problem the syndication industry faced in 1986: the change in existing tax laws and the retroactive application of the Tax Reform Act. With the short useful life assigned to investment real estate (15, 18, or 19 years), high inflation rate, and corresponding high interest rates and low acquisition cap rates, syndications were formed as significant tax shelters for the investors, perhaps even at the expense of economic viability. With the application of the passive loss rules, a longer use life (27.5 years or 39 years), and the end of high inflation, tax benefits disappeared, real estate lost value, and syndications fell on hard times.

Sponsors can do little in the face of changing tax laws and economic factors, but they should search for properties in which the expected benefits are based on sound principles of supply and demand and the recognition of gaps in the market.

Before deciding to sponsor a syndication, commercial real estate professionals should weigh the anticipated profits with the often underestimated risks. As with any investment, strong real estate economics should be the basis for any syndication.

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