OMNI NEWS

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What You Don't See in a PPM

~ Tim Nichols

The Confidential Private Placement Memorandum (“PPM”) is intended to provide full disclosure of all material facts related to the securities being offered. The content of a PPM generally follows the layout and contains the sections required in a registered, or public offering. But as thorough and lengthy as these offering documents may seem, there are typically several areas of important detail that are either incomplete or omitted from the typical PPM. Unfortunately, general discussions covering every possibility have supplanted specific discussions covering what really might happen in any detail. Further, authors of these PPMs do not analyze the economics of the transactions and therefore are not capable of providing the financial analysis an investor needs to consider. This article will highlight several areas where it might be prudent to ask more questions.

The typical PPM will cover a description of the offering, a description of the asset, management, capitalization, use of proceeds and fees, risks and confl icts and summary discussions of related agreements that will be attached as exhibits. Theoretically, this should cover everything you need to know but drilling down a little deeper there remain many open questions. For example, do you know what really occurs at the minimum offering? Can investor funds be released from escrow without the bridge financing being in place? Will the bridge terms affect the investors return in any way? On the real estate side, there are obviously many questions regarding value, competition, environmental and physical condition if there are no professional reports available at the time of the offering.

A big weakness of PPMs is the disclosure of specific property issues. How can you tell whether the property is handicapped by its location (it might be in a great market but is it visible, accessible, is parking really adequate) or physical condition (obsolescence, style, ingress/egress)? Unplanned for capital expenses can ruin the economics of an investment by wiping out yield, requiring capital calls or encumbering a property with additional debt. Visiting properties is critical, and talking to local industry participants is vital to your understanding of the asset. Much of the information you will glean is very useful but difficult to describe in a PPM.

Financially, unlike what the PPM provides you, you need to determine the real level of leverage, not debt to total investment cost? Is the property refinanceable at the same leverage? Consider a 7% cap deal with interest only fi nancing at 70% - if cap rates move against you or if value or NOI declines for any reason, can you refinance or will the investors have to come up with more equity? Who will cover the costs of the refi? Often times, funds will need to be fronted before funding. Separately, if full loan terms are provided in the PPM, you might review the loan application or commitment to obtain a greater understanding of the loan terms.

Tax opinions. Clearly, you want a strong opinion that the acquisition of tenant-in-common interests will not be deemed an acquisition of partnership interests for tax purposes. But what are the assumptions made by the law firm and what are they not opining on? You do not have to guess what their opinion doesn’t cover as they are usually very careful to say specifically what they don’t cover. These items need to be reviewed and considered as to their materiality.

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Management. Broker/dealers are good to screen about management capabilities, but the area of track record understanding and disclosure has been elusive to the industry. The SEC Guide 5 format is terrible and the typical list of equity raised does not help you determine if the prior investments have performed. This is an area that requires answers beyond those provided for in the PPM. Revenues, NOI and distributions need to be compared to original projections. Balance sheets need to be reviewed for reserve balances and working capital positions. Often, distributions are made at the expense of mounting accrued liabilities.

This is certainly not an exhaustive list of considerations when reviewing a PPM. However, it clearly shows that there is so much more to know and understand about the real estate, the offering and the people behind it. Despite our industry’s best efforts, there is no single solution or checklist to cover all the bases. Accordingly, careful reading, plenty of information sharing, direct questioning and fishing for more information is required to really understand what you are getting into as you cannot fully rely on the PPM discussion.