REAL ESTATE SYNDICATION INVESTMENTS: RISKS AND REWARDS

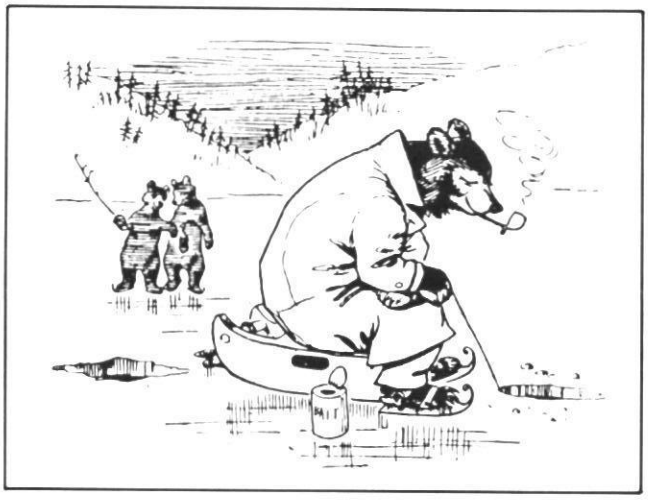
by David B. Blenko

Real estate syndication investments have become extremely popular in recent years. Annual sales of syndication interests have increased over 300% since 1979 and estimates are that the industry raised in excess of $15 billion in partnership capital during 1983. This article examines the origins and impact of the heightened popularity of these investments. It focuses on risks inherent in tax oriented real estate private placements in particular, and recommends syndication evaluation criteria for the individual investor's use.

Reasons For Increased Real Estate Syndication Activity

Favorable tax laws have contributed a great deal to the recent popularity of real estate syndications. In 1978 legislation passed imposed "at risk" provisions on virtually all tax shelter oriented investments except real estate. This exemption provides the investor in a real estate syndication with the unique ability to deduct losses to the extent of not only his or her investment but also his or her prorated share of all nonrecourse partnership debt. Therefore, real estate tax shelters can offer more tax deductions per dollar invested than alternative tax oriented investments. At the same time, with the shortening of allowable depreciation lives for real estate under ACRS, the tax benefits associated with real estate ownership are proportionately greater than before. The combination of these two developments has enabled syndicators to structure partnerships which are very attractive to tax motivated investors. Sales of real estate limited partnerships have also benefited from the weak market for oil and gas partnerships, a traditionally attractive alternative for tax motivated investors.

Although favorable tax laws have benefited the real estate syndication industry, they do not fully explain the



recent popularity of these investments. From the investor's standpoint, not only do real estate syndications represent an inflation hedge, but also a number of syndications recently have had good performance records. Several public offerings have reported average returns to investors of 15–20 percent per annum and many private placements have reported even higher returns. Of course, many of these partnerships were formed during the mid-1970s and enjoyed substantial price appreciation during the inflationary years of the late 1970s. Property investments today may not enjoy the same degree of success.

A change in securities laws has also led to increased sales of syndication interests. While the number of investors in any private limited partnership formerly was restricted, Regulation D (effective April 15, 1982) established a number of exemptions which effectively enabled syndicators to sell to accredited investors an unlimited number of interests in a partnership. As a result, general partners can privately syndicate larger properties and avoid the more restrictive SEC

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requirements which apply to public syndications. The marketing of syndication interests has also grown more sophisticated. Not only have major investments firms become active in the business, but also major syndicators have developed independent sales networks of their own. At the same time, sophisticated packaging and product differentiation are more prevalent as syndicators develop products directed at different investor markets (e.g., IRA/Keogh plans, and tax shelter oriented individuals).

All of the above factors have contributed to the increased public recognition of, and demand for real estate syndication investments. While a number of circumstances have changed and benefited the syndication industry, including changes in tax and securities laws, the investor should not necessarily assume that syndication investments today will perform as well as many did in the 1970s.

The Impact Of Syndication Industry Growth

As a result of their successful equity sales efforts, real estate syndicators have become increasingly significant players in real estate markets nationwide. For instance, recent articles have quoted insurance company executives as concerned about their inability to compete with syndicators for properties which would have sold in the institutional market before the marked increase in syndication activity of the past three years. As an indication to the extent of syndication involvement in real estate markets, assume $15 billion of syndication equity capital was raised in 1983. If 20% of this capital went to syndication fees and the remainder was used to acquire real estate with 75% leverage, then syndications conceivably were involved in transacations valued at $48 billion in 1983 alone. The following discusses the impact of this growth on the industry and opportunities for the investor.

One natural by-product of syndication industry growth has been the emergence of large syndication firms. Many of these syndicators have developed to the point where they are proficient in all the various syndication related disciplines (i.e., acquisitions, property management, investor relations, etc.). In fact, some firms are involved in a range of businesses of which syndication is only one. One large syndicator sponsors a REIT and develops real estate for its own account, in addition to syndicating. Other major syndicators have chosen to restrict themselves to a more narrowly defined business. One syndicator until recently was involved exclusively in the purchase, syndication and management of apartment properties. In any event, there has been a major change in the profile of the real estate syndication industry. At one time many syndicators were small operators and the industry, in general, had a somewhat unsavory reputation. Now a group of well capitalized and professional syndication firms have emerged where investors can buy prudent and profitable syndication investments. Some syndication firms have benefited from their association with the financial and management resources of a public company.

Despite the development of some capable and financially strong syndicators, however, there have been some worrisome consequences resulting from the recent growth in the syndication industry. In particular, the increase in the amount of equity raised for real estate syndications has led to upward pressure on real estate prices as syndicators compete for product in a seller's market. This phenomenon has led some syndicators to pay prices which many consider excessive. Such purchases are justified by their sponsors in terms of tax benefits to investors in the short term and property appreciation potential in the long term. However, substantial improvement in the operating performance of the acquired property is often necessary in order for such syndications to generate the returns to investors projected by the sponsor.

As a result of this increased price competition for properties, some syndication groups are likely to overpay for property and suffer poor returns on their investments. Some have even predicted the syndication industry will go the route of the REIT industry in the 1970s. However, while there are some parallels between REITs and syndicators, there are major differences. First, the REITs which experienced the greatest difficulties were in construction and development. These REITs generally were spread lenders and were lenders of last resort. As a result, they were vulnerable to upward movements in short term rates and many made loans secured by less than top grade real estate developed on a speculative basis. In contrast, many syndications today are conservatively capitalized with 30–40% investor equity and long term fixed rate debt, and are buying preleased institutional quality real estate. While there are obviously exceptions to these rules, there are enough differences that any problems faced by the syndication industry should be less severe than those of the REITs. This is especially true in the wake of changes in federal tax laws passed in 1984 which will discourage abusive real estate tax shelters.

While it seems likely that the syndication industry as a whole will not experience the kind of shakeout experienced by the REITs, there are likely to be some problems. As a result of price competition and the recent IRS crackdown on abusive tax shelters, some syndication investments inevitably will produce poor returns for investors. It is therefore the responsibility of the individual investor to analyze any syndication investment thoroughly before investing, preferably with the assistance of a qualified professional.

Risks In Real Estate Private Placements

A majority of the syndications sold in recent years have been real estate private placements. In contrast to public real estate syndications, which historically have been required to raise all investor equity in up front, lump sum payments, private placements can be structured so that partners submit their equity contributions in installments

over a period of years. By staging partnership contributions in this manner, the syndicator can match investor payments with offsetting tax benefits and, in effect, minimize the investor's annual net cash outflow. For instance, an investor in the 50% tax bracket who receives $2 or more of tax deductions annually for every $1 contributed to a partnership should receive immediate tax savings sufficient to cover the cost of his or her contribution. While such investments can not totally eliminate income taxation, they do offer two potential tax benefits: (1) the conversion of ordinary income into long term capital gains, and (2) the deferral of tax payments until the sale of partnership property. Thus, these investments are popular for understandable reasons including the potential for tax savings in the short term and property appreciation and cash flow in the long term. However, they present several risks which investors should be aware:

Disallowance of Tax Deductions—Although The IRS rarely disallows a significant percentage of the projected tax benefits from a conservatively structured real estate syndication, it may do so when a gross overvaluation of a property or overly aggressive tax accounting practices lead to inflated write-offs for investors. In searching for such abuses, the IRS will direct special scrutiny to syndications offering write-offs in excess of 2:1. An investor can derive comfort regarding tax aspects of a syndication with a tax opinion from a reputable law firm which opines that "more likely than not" a majority of the projected tax benefits are likely to withstand any IRS examination. This assurance also can result from an MAI property appraisal.

Foreclosure by Lender—A lender's foreclosure on a syndication owned property is likely to have a more severe impact on investors than an IRS disallowance of tax benefits. Not only will a foreclosure result in the loss of tax benefits, but also it is likely to result in unexpected tax obligations for investors due to recapture of accelerated depreciation and penalties for debt forgiveness. Investors can protect themselves against the threat of foreclosure by carefully examining partnership pro formas to determine whether the partnership will be liquid enough to fulfill its scheduled debt service obligations in the short term, and by assessing the property's long term prospects to determine whether the partnership will be able to comply with the terms of its mortgage debt. This includes any requirement to make a short-term "balloon" principal repayment (often due three—ten years after acquisition of the property). It is especially important to focus on these points because, under certain circumstances the investor may lose more than the amount of his or her original cash investment.*

Excessive Purchase Price—Many syndicators today are paying such aggressive prices for properties that their syndications are not "economic" real estate investments in the traditional sense. Cash flows from their property acquisitions do not initially cover their related mortgage debt service. These cash shortfalls may be offset by investors' cash contributions in the short term. But the long term economic viability of such investments generally will depend on increases in net cash flows from the property. In the absence of such increases, the syndication group may face foreclosure or, even if a property is not lost to foreclosure, minimal returns to investors. This risk to investors is further heightened by the fact that syndicators' economic interests and theirs do not necessarily coincide. Because syndicators typically receive large up front fees regardless of the returns to limited partners, syndicators may have a strong incentive to syndicate properties even if the purchase prices paid are inflated. Again, to protect against this risk, it is important to carefully assess the property's short and long term prospects and to critically evaluate the syndicator's assumptions in these areas.

Reliance on Financial Strength of Sponsor—The investor also should realize that the general partner's financial position is important in determining the financial viability of a limited partnership investment. A limited partnership typically will run five to ten years. It is quite possible that there will be temporary cash flow shortfalls relative to budget during that period, even if the investment has been conservatively structured and performs well in the long run. Therefore, because the general partner typically will have a limited ability to make additional capital calls on limited partners, he or she must have the financial strength necessary to support not only the subject partnership but also all other such partnerships he or she has sponsored.

Reliance on Sponsor's Organization—Real estate syndication is a very complex business. To be effective a syndicator must be strong in a number of diverse functional areas including acquisitions, securities laws, tax planning, property management, investor relations, marketing and accounting. If any one of these areas is weak, it can hurt the syndicator's overall operation and eventually affect any partnership sponsored by the syndicator. For example, if a syndicator fails to provide timely tax information to investors, they may delay their installment payments. This causes liquidity problems for the general partner thereby hurting all affiliated partnerships. If the general partner does not ensure that partnerships he or she has sponsored are in full compliance with a myriad of IRS and SEC regulations, the consequences for a partnership can be very damaging. In addition, if the general partner does not remain actively involved in property management, partnership properties may not perform up to their full potential or may even suffer physical deterioration. The investor should determine that the sponsor of any potential syndication investment has the expertise required to maintain the viability of the investment.

Investor Defaults—In real estate private placements, deferred investor equity contributions represent a significant source of partnership funds. If a large number of investors in a partnership defaults on these payments,

*Pilzner. "You Can Lose in the Wrong Syndication Investment", *Real Estate Review* (Spring 1984).

the partnership's liquidity position will be impaired. Although investor defaults have not been a major problem for the syndication industry, and the historical default rate has been less than one percent, the investor can verify that the syndicator has minimized this risk by establishing adequate minimum financial standards for investors. Also, investors are more likely to be well qualified for future payments if their first year down payment is substantial (20–25% of the total investment). This risk will be further mitigated by the fact that investors have a significant incentive not to default because a default triggers adverse personal tax consequences. Also, in the unlikely event that an investor does default after making one or more installment payments, the general partner should be able to remarket the limited partnership interest if the syndication continues to meet projections. Surety bonds or letters of credit backing investor notes will provide even greater security for the partnership. Of course, the best protection against investor defaults will be a conservatively structured syndication which meets investor expectations.

Syndication Evaluation Criteria

To minimize the above risks, the investor (or a qualified professional acting on behalf of the investor) should thoroughly analyze the merits of any syndication investment just as a lender would in considering a loan to a real estate investment partnership. This analysis can include an assessment of the general partner's organization strength, track record and financial position to insure that he or she has the capacity to manage the property investment; a verification that the general partner has not had any prior significant disallowances or problems with the IRS or SEC; an evaluation of each property acquired; an analysis of underlying mortgage debt and its terms; and a verification that the qualification standards for investors are stringent enough so that other investors would be likely to make future required equity contributions. In addition, the investor can require a complete legal opinion covering tax aspects of a syndication, as well as an MAI appraisal.

It will be particularly difficult for the investor who is not a real estate expert to evaluate a syndicator's property cash flow projections, especially when the projections assume a substantial improvement in net cash flows from a property. It is essential for the investor to determine these assumptions are not overly aggressive. This analysis will be difficult because it will be prudent in some cases for a syndicator to project that there *will* be significant increases in property cash flows. For instance, the syndicator acquiring the subject property may have a property management capability which is far superior to his or her predecessor's. Alternatively, rents in the vicinity of the subject property may be escalating far faster than expenses. Nonetheless, the risk to the investor is that the syndicator has assumed a series of annual increases in net cash flow which cannot be sustained, and are not warranted given the specifics of the property and its market. Such syndicators may be doing nothing more than unwittingly betting on inflation. Just as with oil prices, this can be a very dangerous area in which to speculate. In cases where the assumed annual increases in net property cash flow appear excessive, the reason simply may be that the syndicator overpaid for the property. In other words, in such cases substantial increases in cash flow may be required to justify the purchase price. Of course, what are reasonable assumptions in this regard will depend on the subject property and market as well as the capabilities of the syndicator. Again, it is recommended that the investor enlist the services of a qualified professional in this evaluation.

A complete due diligence examination of a syndication investment as outlined above should establish with a reasonable degree of certainty that: any IRS disallowance of tax benefits should not have severe adverse consequences for the investor; the partnership owned property's performance should at least come close to meeting operating projections; to the extent that the property does underperform versus budget, the combination of operating reserves built into the deal and the financial strength of the general partner should be sufficient to maintain the viability of the deal; and if the above conditions are met, the partnership should not suffer from large-scale defaults by investors unwilling or unable to make their deferred equity contributions. If these conditions are met, the chances of a major disappointment with a syndication investment will be minimized.

Summary Recommendations

Investors should consider investing in real estate syndications on a selective basis because they offer the potential of very attractive after-tax returns. Moreover, due to the growth of the syndication industry, there are any number of sophisticated and well capitalized syndicators. However, because of the substantial risks inherent in many syndication investments, investors should not make any investment without a thorough analysis of the syndication and the qualifications and track record of the syndicator, preferably with the assistance of a qualified professional.

The reputation of the syndicator should be a major consideration in the underwriting process, particularly since the success of the syndication will depend on the syndicator's ongoing involvement in property management and investor relations. It is also important for this analysis to determine how aggressive are the syndicator's property cash flow projections, and to evaluate the strengths and weaknesses of the property and its surrounding market. Such a careful examination will help protect the investor against a major syndication disappointment.