

# Rod Khleif Presents:

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Why Senior Housing Might be the Smartest Investment of the Decade

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# Introduction

It is a well documented fact that, following the end of World War II, there was a baby “boom” as soldiers returned from the front and began to settle into domestic life. In total, the result turned out to be the creation of one of the largest generations to have ever been born in the United States - known as the Baby Boomers.

The “Baby Boomer” generation refers to the individuals who were born between 1946 and 1964 - some 76,000,000 people million in all - many of who are now at or nearing retirement age.

The first of the Baby Boomers began to reach retirement age in 2011, and what started as a trickle is going to turn into a coming tsunami of individuals reaching retirement age and beyond. In fact, in 2025 the “Silver Tsunami” is expected to see nearly 8,000 people *per day* reach the age of 75.

What does this mean? Well, a combination of factors including increasing longevity, a higher percentage of elderly citizens living alone, chronic under investment in senior housing, and fewer adult children around to help means that our rapidly aging population is going to need a place to live and people to help them age gracefully.

Why does this matter? From an investment standpoint, it matters because we think that it makes Senior Housing one of the smartest investments of the decade.<sup>1</sup> Are you going to capitalize on it? I’m here to help.

In this book, I’m going to tell you how to capitalize on the “Silver Tsunami” by discussing:

- *What, exactly, “Senior Housing” is and the different types of properties that you may encounter*
- *The supply and demand imbalance in the Senior Housing market*
- *The risks and benefits of investing in Senior Housing*
- *The economics of Senior Housing and how they make money*
- *How to invest in Senior Housing and plan for a profitable exit*
- *How to analyze operators and ensure they deliver returns*
- *How to analyze and manage your Senior Housing investment portfolio*

Whether you’re new to real estate investing in general or looking to diversify your existing real estate investment portfolio, this book is your roadmap to making a successful investment in a recession resistant, high demand asset class whose future looks very promising.

Let’s get started.

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<sup>1</sup> Some investments are only available to “Accredited Investors” who have a net worth of \$1,000,000+ or \$200,000+ in annual income. See [Rule 501 of Regulation D](#) for complete details on what makes an Accredited Investor.

# The Coming “Silver Tsunami” and Demand vs. Supply

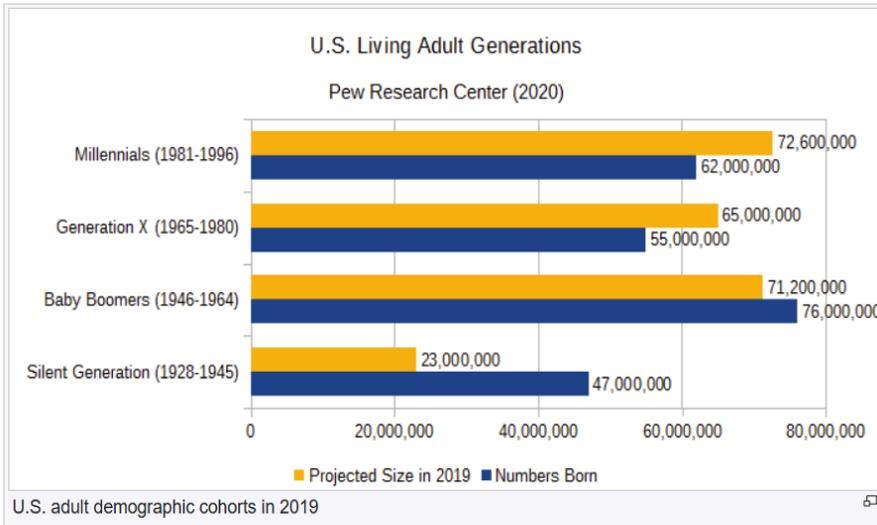
In the simplest possible terms, the core of the investment thesis for Senior Housing centers around the significant imbalance between demand and supply - which can be incredibly favorable for investors. Let's talk about both sides of this equation in more detail.

## Demand

As I mentioned in the introduction, there was a significant baby boom that occurred between 1946 and 1964, driven primarily by soldiers returning from World War II who wasted no time settling into domestic life. In terms of size, there were 76,000,000 people born into the Baby Boomer generation, and the total size of this cohort was 71,200,000 by 2019. As a generation, Baby Boomers are second only to Millennials in size. The youngest

baby boomers reached age 75 - an age around which housing discussions typically begin - around 2021. From this point, the initial trickle of Baby Boomers who may need dedicated housing is expected to turn into a “Silver Tsunami” over the coming years, with more than 8,000 people *per day* turning 75 by 2025.

This fact alone is the driving force behind the expected surge in demand for Senior Housing over the coming years; however it isn't the only element.



There are a number of other factors that are also expected to drive the expected demand. They include the following:

- **New Household Formation:** The number of adults aged 75+ who live alone is expected to double by the year 2040. This dramatic increase in single member households is expected to drive demand for single occupancy senior housing units.
- **Divorcees:** The percentage of divorcees aged 50+ is expected to increase from 27% in 2010 to 40% by 2022. These divorcees often find themselves living alone into their older age.
- **Adult Children:** In today's economy, it is common for adult children to gravitate towards major metropolitan areas - such as New York, Los Angeles, Miami, or Denver - for work. As a result, it means that there are fewer adult children around to help as their parents age and/or house them.
- **Longevity:** It is a simple fact that with the benefit of modern medicine and healthier lifestyles, individuals are living longer than ever. At present, the average life expectancy for both men and women is 78.4 years, with men expected to live to 75.8 and women to 81.1. Longer lives means a longer period of time living in senior housing and/or less turnover.

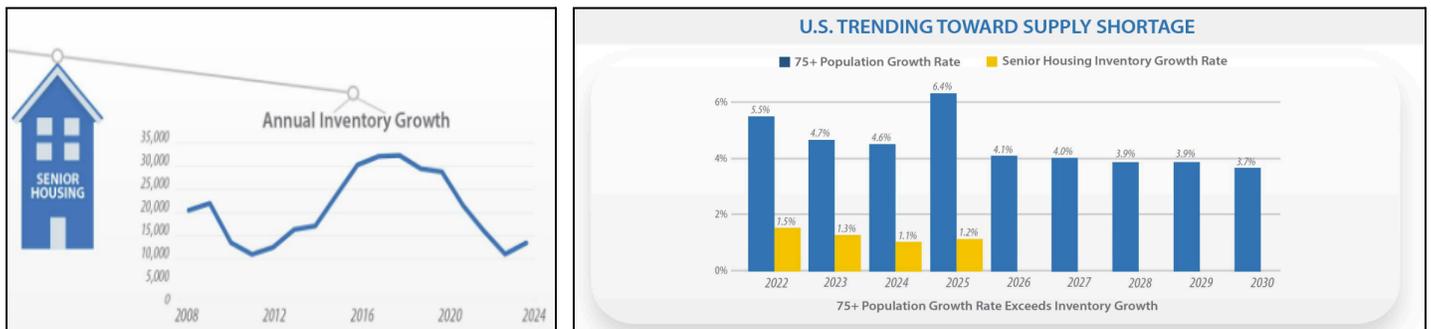
The point is this, from the demand side, there is a coming surge in demand for Senior Housing driven by Baby Boomers reaching age 75 combined with more and more seniors living longer and living alone, and fewer adult children around to help. To complicate this problem, supply of senior housing hasn't been able to keep up.

## Supply

The expected surge in demand for senior housing is complicated by the fact that supply simply isn't up. From the chart below, it can be seen that annual inventory growth of Senior Housing reached a peak in 2016/2017 at ~30,000 units per year. Since that time, it has inexplicably fallen to ~10,000 units per year by 2025 (see chart below from the NIC).

According to the National Investment Center (NIC) the US needed an additional 156,000 units of Senior Housing by 2025. At the current growth rate, it would take nearly **15 years** to build the required inventory, assuming no additional growth in the population of seniors needing housing.

Or, put another way, as of 2025, the population of individuals who are 75+ is growing at an annual rate of 6.4% while the inventory of senior housing is growing at an annual rate of 1.2% (See the chart below from the NIC).



## Conclusion

The demand vs. supply characteristics of the Senior Housing market are no doubt unique - there is expected to be a significant and sustained surge in demand for senior housing units and there isn't nearly enough supply to accommodate it - which sets the stage for future senior housing price growth and market-beating investment returns.

So, if the investment thesis is clear, the next most logical question is "how can I capitalize on this opportunity?" In the remainder of this book, I am going to tell you how to do just that - starting with a definition of exactly what senior housing is.

# What is “Senior Housing?”

Now that we’ve made the case for why senior housing presents an attractive investment opportunity, let’s talk about exactly what it is because it is a lot more nuanced than just “housing for the elderly.” There are actually many different types of senior housing and potential investors should understand their definition, pros, cons, and nuances because there are investment opportunities across each. Let’s talk about them in order from the most independent to the least.

## **Age Restricted Multifamily**

Age restricted multifamily housing is exactly what it sounds like. It is a multi-unit development - usually apartments - that is only available to residents that are at or above a certain age - usually 55. Often developers/investors of Age Restricted Multifamily can qualify for federal tax benefits under the Housing for Older Persons Act (HOPA) as long as a minimum of 80% of the available units are occupied by someone who is 55 or older (NOTE: The exact age requirement may vary by community).

Given their focus on older individuals, age restricted multifamily communities are often located near mass transit options (trains, buses, or light rail) and/or medical facilities such as hospitals or medical offices and some may even offer dining options for their residents.

For residents, the benefits of living in an age restricted multifamily community include the ability to continue living independently in a low maintenance setting as well as a host of amenities such as pools, gyms, pickleball courts, and community gathering spaces. In addition, many communities take an active role in social programming to ensure that residents have ample opportunities to socialize and make new friends through planned activities.

The downside to living in an age restricted multifamily community is that they can be expensive and they may not offer all of the support services that older residents may need.

From an investor standpoint, age restricted multifamily isn’t much different than a non-age restricted multifamily community. They can provide stable income, investment growth, tax benefits, and portfolio diversification. The downside is that these types of investments may not be available to everyone (they require investors to be accredited), they may require high minimum investments (e.g. \$50,000), and investors generally don’t have a say in the day to day operations of the property.

## **Independent Living**

Independent living communities are for seniors who still have the health and ability to live on their own, but may want additional support and services to live a maintenance free lifestyle.

Typically, Independent Living residents live on their own in an apartment or home within the community and are able to take advantage of all of the amenities available on site. For example, many communities offer on site dining, housekeeping, laundry, transportation, and security. In addition, independent living communities may offer a full social calendar of activities, beauty shops, fitness centers, libraries, and plenty of outdoor spaces like walking paths, picnic areas, and pools.

From a resident perspective, the benefits of being part of an independent living community are obvious - they get all of the benefits of an active, independent lifestyle, without any of the hassle of managing their own space.

The downside is that they can be expensive and they can be in short supply so there can often be waiting lists for entry. In addition, independent living communities often don't have onsite medical care and it can be difficult for future residents to downsize enough to enter an independent living unit.

From an investment standpoint, the benefit of an investment in an Independent Living facility is the opportunity for stable, recurring cash flow generated by rental payments as well as the ancillary services provided by the file. In addition investors may benefit from opportunities for rental increases due to favorable supply/demand characteristics. Finally, investors may be able to realize a reduction in taxes due to favorable tax treatment of Independent Living investments.

The downside from an investment standpoint is that there may be competition that could limit upside. In addition, the operating expenses of independent living communities is likely to be higher than a typical multifamily property due to the cost of additional services.

### **Assisted Living**

In terms of assistance, an Assisted Living facility fits somewhere in between Independent Living and Skilled Nursing or Memory Care. It is a residential living facility that provides seniors with the ability to live, mostly, on their own, but provides support in areas such as:

- Bathing and dressing
- Managing and/or distributing medication
- Grooming and using the restroom
- Transportation (to/from doctor appointments or other engagements)
- Housekeeping
- Social activities

In addition, Assisted Living facilities often have staff who are present 24/7 to assist residents in the event of an emergency or some other unexpected need that arises. From this definition, it can be seen that the key difference between Assisted Living and Independent Living is the amount of support provided to residents. To this point, Assisted Living properties are often a good fit for those who are no longer able to live completely on their own and/or those who want to continue to live independently, but with opportunities for social activities and community building.

For residents, the benefit of an Assisted Living community is obvious - they are able to live in a supportive community that provides the services and support they need as they continue to age. The downside is simply that Assisted Living facilities can be very expensive with monthly fees typically starting around \$4,000 and going as high \$8,000 or higher, depending on the specific level of support needed.

For investors, the benefit of owning/operating an Assisted Living facility is simply that the demand for these types of properties is significant - meaning that they typically stay full with rent paying residents. The downside is that Assisted Living properties have higher operating costs than a typical multifamily property and there can be an additional level of operational complexity that comes with supporting the medical needs of residents.

### **Skilled Nursing**

A Skilled Nursing facility is not so much a long term care solution as a short term, intensive care, rehabilitation facility where seniors can go to recover from an injury. In addition to a place to live, Skilled Nursing facilities typically offer the following services:

- Physical, occupational, or speech therapy
- Ongoing medical care, such as medication management and/or constant monitoring of vital signs
- Dietary services
- Recreational opportunities

By definition, a Skilled Nursing facility is not meant to be a long term solution. Instead, it is meant to be short term, transitional housing that allows individuals to recover from an injury (such as a fall) before going back to their longer term home.

From a resident standpoint, the benefit of a Skilled Care facility is that they provide the support and care necessary to recover fully from an incident. Once again, the downside is that they can be very expensive, can be difficult to find an available room given the demand, and the quality of care can vary greatly from one facility to another.

From an investor standpoint, the benefit of owning/operating a Skilled Nursing facility is that demand for them is high so they tend to have strong occupancy rates. In addition, owner/operators may benefit from tax breaks and/or subsidies from the government for taking care of our most vulnerable residents. The downside is that the operating costs can be significant since these facilities need to be staffed by qualified personnel such as nurses and physical therapists - which can be hard to find and expensive to employ.

### **Memory Care**

Finally, the most supportive type of care is “Memory Care,” which is specifically designed to care for residents with memory issues such as Alzheimer’s disease or other forms of dementia. In this regard, they are part residential living that provides a secure place to live for those with memory issues and part medical facility that provides specialized support, including:

- Specialized staff with training and experience in dealing with patients that have memory issues
- A secure environment with locked doors and enclosed spaces that prevents residents from wandering off site
- Structured activities and therapies to help minimize any effects from loss of memory
- Personalized care plans
- Assistance with daily living activities such as bathing, eating, and dressing
- Cooking and cleaning

In short, Memory Care facilities provide the highest level of support for the most vulnerable seniors. For residents, the benefit is obvious, they get a high level of personalized, specialized support and care that their families are likely not able to provide on their own - with the hope that they can live their final days with peace and dignity. The downside is that this type of care is incredibly expensive with typical fees ranging from \$6,000 - \$8,000 per month or higher. In addition, obtaining a spot in a local, qualified Memory Care facility can be difficult due to demand.

From an investor standpoint, the benefit of owning and operating a qualified memory care facility is strong demand and high occupancy - which lays the groundwork for potentially solid returns. Again, the downside of owning/operating a Memory Care facility is that they must be staffed by individuals with a high degree of expertise, which can significantly increase operating costs.

## Summary and Conclusions

From this section, it can be seen that there are many different types of Senior Housing - each of which cater to a different segment of the aging population. From both a resident and investor perspective, each type has its own set of advantages and disadvantages. So, for individuals who are considering an investment in Senior Housing, it is important to take the time to evaluate two key elements of an investment in senior housing:

1. Given what we know about the “silver tsunami” - do I want to invest in Senior Housing in general?
2. If the answer is yes, which segment of the Senior Housing market best fits my own investment objectives and goals?

For those that determine that a Senior Housing investment is a good fit for their portfolio, it is important to understand the potential benefits and risks of this investment. We’re going to discuss those in the next chapter.

## Risks and Benefits of Investing in Senior Housing

As a quick recap, up to this point, we have established that the key investment thesis for Senior Housing is that there is a coming “Silver Tsunami” of individuals who will likely need to transition out of traditional housing options - like single family homes - and into some type of Senior Housing depending on the level of care and support that they need or want.

And, because there has been a chronic under investment in new Senior Housing units, the fundamentals of this market are such that the demand is going to far outstrip the available supply of units, which sets the stage for strong occupancy figures and potential rental growth - a perfect setup from an investment standpoint.

So, for those that agree with this thesis, it is important to understand the potential benefits and risks of a Senior Housing investment. This is what I am going to discuss in this chapter.

### Benefits

Given the setup described above, there are a number of incredibly significant benefits of an investment in a Senior Housing property. I’m going to discuss each one in detail below.

#### *Stability*

First and foremost, one of the most sought after benefits of an investment in Senior Housing is stability. As I've previously established, there is significant (and growing) demand for Senior Housing and not nearly enough supply being built. The result is sustained levels of high occupancy/low vacancy and growing rental rates.

For investors, the result is a stable property that should deliver equally stable returns.

### *Income*

First and foremost, Senior Housing investors stand to receive some level of income produced by their investment property. The economics of this equation are fairly simple - the residents of the property pay some amount of rent in return for their space in the property (in general, the required rent will rise along with the required level of care/support). The property operator will use the rental income to pay for the expenses required to run the property on a day to day basis, which includes things like property taxes, insurance, maintenance, transportation, staffing, landscaping, and dining. Hopefully, after all of the expenses are paid, there is some amount of money left over - this number is called a property's "Net Operating Income."

From Net Operating Income (NOI), the required loan payments are made (if there is a loan). Anything left over after the loan payments is eligible to be distributed to investors in the property. For example, suppose a property produced \$1,000,000 in rental income and had \$600,000 in operating expenses, the Net Operating Income for this property is \$400,000. From this \$400,000, there is \$200,000 in annual loan payments, which leaves \$200,000 available to be distributed to investors. If there are 100 investors in this example property, each one could be eligible for a distribution of \$2,000 for that year.

The point is this, Senior Housing properties come with the potential for regular distributions of income, usually quarterly or annually, that can provide an attractive return on investment.

### *Equity Growth*

Again, we now know that demand for Senior Housing is expected to outpace supply of available units. Simple economics tells us that this is a classic setup for growth in rental prices, which also means that there is potential for growth in the value of an investor's equity. To demonstrate how this works, we need to do a bit of back of the envelope math.

For investors, the purchase of a typical property is funded through a combination of debt - a loan from the bank - and equity - cash from investors. The specific mix of debt and equity can vary significantly from one deal to another, but it is typically somewhere in the neighborhood of 70% debt and 30% equity. For example, if an investor was going to buy a property for \$1,000,000, they would do so with a \$700,000 loan and \$300,000 in cash equity which they can supply on their own, in full, or source from a number of different investors.

Over time, as the property is owned, there are two things that are happening simultaneously. First, rental payments are used to make loan payments, reducing the balance and building even more equity. Second, because of high demand, rental amounts tend to rise, which also results in more equity through higher Net Operating Income.

Using the same example above, assume that after five years the property's loan balance had been reduced to \$650,000. In addition, suppose that net operating income had risen from \$150,000 to \$200,000 annually. Senior Housing properties are valued based on something called a "Capitalization Rate" which is a percentage that expresses the relationship between a property's value and the amount of Net Operating Income it produces. At a 7% cap rate, the property's value rises by \$14 for every additional \$1 in Net Operating Income

(\$1 / 7%). So, if a property's Net Operating Income grew by \$50,000, it means that the value has risen by \$714,000.

So, when the loan balance is going down and the value is going up, there is a strong chance that an investor is going to see an increase in the value of their original investment over the long term, which is typically realized upon the sale of the property.

The combination of regular income and equity growth can result in very attractive returns.

### *Tax Benefits*

There are a number of potential tax benefits for Senior Housing investors, but I want to concentrate on three in this book - Depreciation/Cost Segregation, 1031 Exchanges, and Government Programs.

### Depreciation and Cost Segregation

This one can get a little bit wonky, but bear with me because it is all about tax savings.

Over time, a property's condition gets worn out - the carpet gets dirty, the paint chips, the air handling unit gets older, the outside of the property (including the roof) gets exposed to weather, and the furniture and fixtures age. To account for this, accounting rules allow an owner to "depreciate" a portion of its value each year. The depreciation shows up as a non-cash line item expense on the income statement that serves to reduce the taxable income for property - and for those that invest in it. For this reason, it is in an investor's best interest to maximize the amount of allowable depreciation taken each year.

One of the most common ways to maximize depreciation is a strategy known as "Cost Segregation." As a general principle, tax rules allow investors to depreciate their asset over its "useful life," but the components of any given property have different useful lives. For example, a roof might last for 30 years while an air handling unit might only last for 10. Under a Cost Segregation strategy, investors can "segregate" a property into its individual components and accelerate depreciation for certain portions. The net effect of this process is to maximize depreciation and minimize the amount of taxes an investor pays in any given year, while not reducing the amount of cash available for distribution (depreciation is a non-cash expense).

To sum this up, Depreciation and Cost Segregation allow investors to reduce their overall tax liability through an investment in Senior Housing.

### *Low Debt/Equity Correlation & Diversification*

One of the bedrock principles of risk management in an investment portfolio is a concept known as "diversification," which states that it is better to invest a little bit of money in a lot of different assets than a lot of money in just one or two assets. In other words, it is the investment version of that old saying "don't put all your eggs in one basket."

To that end, commercial real estate prices - which includes Senior Housing - tend to have a low level of correlation with movements in the prices of traditional investments like stocks and bonds. This means that commercial real estate prices tend to be stable or go up when stock/bond prices are down and vice versa. For this reason, Senior Housing can provide an excellent element of diversification to the traditional stock/bond investment portfolio.

Although the benefits of a Senior Housing investment can be significant, they don't come without some level of risk. Let's talk about those now.

## **Risks**

Every investment has risk and it is up to each individual to identify the risks in their specific opportunity and to make sure they are comfortable with them before committing their capital.

With regard to Senior Housing specifically, there are a number of potential risks that I want to discuss, including: regulatory challenges, operational complexity, market saturation, labor pressures/shortages, operating cost and operational failure, insurance, and upkeep. Let's look at each of them in detail.

### *Cost*

The operating costs for Senior Housing properties exist on a wide spectrum. For property types like Independent Living and Age Restricted Multifamily, the operating costs are closer to a traditional multifamily property. However, as you get towards the other end of the spectrum with property types like Memory Care and Skilled Nursing the operating costs can increase significantly because of the staffing required at these facilities.

For this reason, it is critically important that Senior Housing investors understand the cost structure of their potential investment. In doing so, they must be confident that the property can produce enough income to pay the necessary operating costs and debt service, while still having some money left over to distribute to investors. If a property's costs spiral out of control, they can present a significant risk to the viability of an investment.

### *Insurance Costs & Litigation*

On the topic of costs, there is one specific cost - insurance - that is vitally important for two reasons. First, for all of their best efforts, it is possible that Senior Housing operators may make a mistake that could result in a fall or some other type of event that results in injury to a resident. If the injury and/or the mistake is particularly egregious, it could result in some type of lawsuit, which could potentially cost the facility and their investors a significant amount of money.

So, for this reason investors must ensure that all properties carry the necessary levels of insurance to protect from lawsuits and other legal events while ensuring that the cost does not impact the performance of the property.

### *Regulatory Challenges/Requirements*

Depending on where an investment property is located or why type of property you are investing in, there may be a significant number of regulatory requirements that a property has to abide by in order to continue operating. While the laws vary widely, they are generally focused on ensuring senior residents are treated with dignity and respect as well as making sure the facility itself is safe, clean, and capable of providing the level of care that its residents require.

For example, the state of California requires state-level licensing for assisted living - which includes required staff training, emergency plans, and adherence to strict health and safety standards for facilities, including specific protocols for cleanliness, medication assistance, and accessibility.

Not only does regulatory compliance increase a property's operating expenses, it also increases the risk profile of a transaction because the penalties for non-compliance can be significant - up to and including monetary fines or closing of the facility entirely. For this reason, it is imperative that investors ensure they are working with a knowledgeable and experienced operator.

### *Operating Complexity*

Depending on the type of Senior Housing that you are investing in, the degree of operational complexity can vary significantly from one property type to another. For example, Independent Living and Age Restricted Communities are much closer to a traditional multifamily investment in terms of operating complexity whereas Skilled Nursing and Memory Care facilities require extremely specialized support staff, equipment, and design.

For this reason, investors should be confident that they are working with operators that have the required expertise and familiarity with the types and levels of care needed to safely and effectively operate the facility. If they don't they may run afoul of regulatory requirements and/or develop a bad reputation which means that occupancy and return levels could suffer.

### *Market Saturation*

Yes, we have previously argued that the market is not building nearly enough senior housing to satisfy expected demand. While this is true, it does not mean that it will always be true. Frequently, when developers see a market opportunity, many rush to fill it which increases the risk of market saturation for the Senior Housing product.

If, in three or five years, a market has too much senior housing, the laws of supply and demand dictate that occupancy is likely to suffer and/or rental rates will have to correct to a lower level to attract new residents. As a result, returns could suffer.

For this reason, it is important for investors to carefully analyze not only the existing supply of Senior Housing but also the future planned supply for a given market to ensure it won't get saturated.

### *Labor Pressures/Shortages*

Staffing in Senior Housing properties is notoriously tricky and it all has to do with cost.

Operators need to ensure that they have the right level of specialized support to ensure that residents are safe, healthy, and happy. However, they have to keep a close eye on costs to keep rents and costs competitive with other facilities in the market - especially for the facility types that require higher levels of specialized care. For example, Memory Care or Skilled Nursing facilities need to employ licensed and competent medical professionals to properly care for residents, but they are expensive and difficult to find.

For potential investors, it means that it is a best practice to carefully analyze planned staffing levels, expertise, and cost to ensure that their cost does not make the property uncompetitive with others in the same market.

### *Operating Costs/Operating Failure*

As I mentioned above, cost containment in a Senior Housing property can be tough because there are so many competing pressures. On one hand, you have compliance with regulatory requirements, staffing levels, and the increased complexity of providing specialized care - all of which can be expensive. On the other hand you have investor appetite for an attractive return, which can make it tempting to cut corners on cost.

But, cutting corners on costs is a very short sighted and risky approach. The best investors know that it is critically important to maintain a property, which means consistent capital investment over time, to ensure the long term viability of the property. Failure to do so can have severe long term consequences for residents, owners, and investors, which include fines, a bad reputation, and even the closure of the property if it gets to a point that it cannot support itself.

### *Modernization & Upkeep*

Finally, the last risk that I want to discuss is modernization and upkeep. Like any other property type, Senior Housing facilities will degrade over time. However, unlike other property types, it can be difficult and/or incredibly expensive to modernize Senior Housing because of the specialized equipment needed and the vulnerability of the residents.

So, to ensure that a property is always staying up to date, Senior Housing investors must ensure two things. First, they must ensure that they are working with a reputable, experienced, operator who knows what it takes to keep a property in good, clean, and safe condition. Second, investors must ensure that the property manager/operator is setting enough money aside on a regular basis to pay for future capital improvement projects. For example, an air handling system or roof or interior renovation can be very expensive. So, to minimize any significant impact to cash flow, managers should set a little bit of money aside every month (called Capital Reserved) so they can effectively manage the cost of these big ticket repairs. If they aren't, it likely increases the risk profile of the transaction.

### **Final Thoughts**

No matter the investment, there are risks and benefits to consider. For Senior Housing specifically, it is critically important for investors to carefully consider the upside (the Benefits) while protecting the downside through proven risk mitigation strategies like portfolio diversification and working with an experienced reputable operator who will be a good steward of their funds.

Once you are comfortable assessing the risk profile of a transaction, the next thing to think about is the performance of the property itself. So, in the next chapter, I am going to review - at a high level - how to evaluate the performance of a Senior Housing property.

## The Economics of Senior Housing & Doing Your Research

In the most general sense, the economics of Senior Housing are relatively simple - they generate income through rent and support services and use that rental income to pay for the property's operating expenses and debt service. If the property is profitable, there is a little bit of money left over after all expenses have been paid to distribute to investors.

With this concept in mind, I want to break down each component of the income statement so you know where the money is coming from and how much to expect. Let's start with income.

### *Income*

A property's income is critical to its success. In Senior Housing, there are a number of ways to produce income:

### Base Rent

The primary source of income for a Senior Housing property is the Base Rent, which is exactly what it sounds like. Base Rent is the amount of money that residents pay for the privilege of occupying their apartment and for

access to the property's amenities. In Assisted Living and Memory Care facilities, Base Rent may also include access to certain basic services.

Base Rent is typically measured on a per unit basis and can vary widely depending on a property's location, services provided, and level of finish. The following bullets provide a general guide for Base Rental amounts by property (per month, per unit):

- Independent Living: \$3,000–\$5,000
- Assisted Living: \$4,000–\$6,500
- Memory Care: \$6,000–\$8,000 ([NIC.org](http://NIC.org))

So, for example, assume that you were considering an investment in a 50-unit Independent Living facility where the rents averaged \$4,500 per month. As an investor you would expect \$2,700,000 ((50\*\$4,500)\*12) in annual Base Rental Income.

### Care Services / Assisted Living Fees

In addition to Base Rental Income, residents may also have to pay extra fees for Care Services - which is assistance with daily activities like bathing, dressing, and medication management. Memory Care residents may pay a premium for these services given the extra time and attention that they may need.

For Assisted Living and Memory Care facilities, care services can contribute 25–35% of total revenue in AL and MC. So, continuing the example above, if the property produces \$2,700,000 in Base Rental income, Care Service revenue could produce an additional \$675,000 - \$945,000 in annual income. Facilities with premium care offerings (Memory Care and Skilled Nursing) could even command a bit more.

### Ancillary Services

In addition to Care Services, Senior Housing properties may generate additional income from “Ancillary Services” which could include things that are not covered under basic care - such as therapy, rehabilitation, transportation, salon/spa services, and wellness programs. In addition, higher end communities may also offer concierge services or partnerships with external providers for additional revenue.

For investors and operators, Ancillary Services can be a relatively low risk way to boost revenue while enhancing resident satisfaction. They may also be able to differentiate one property from others in a competitive market.

There is no typical benchmark for Ancillary Services, but it is fairly common for operators to offer them to potential residents on an ad hoc or a la carte basis. For the purposes of this book, assume that our example property produces another \$100,000 in income.

So, if our example property produces \$2,700,000 in Base Rental Income, \$750,000 in Care Services revenue, and \$100,000 in Ancillary Income, the total income for the property would be \$3,550,000 - which is the starting point to pay for the property's operating expenses.

### *Operating Expenses*

A property's operating expenses are just that - the costs it takes to operate the property to a standard that ensures all residents are safe and happy while putting aside enough money for future capital projects like a new roof or new air handling unit. Let's talk about some of the major expenses that an operator is likely to encounter.

### Staffing

A typical Senior Housing facility includes a number of different staffing types - from nurses, front desk, porters, maintenance, and drivers, a Senior Housing property requires much higher levels of staffing than a typical multifamily apartment complex.

For this reason, staffing is by far likely to be a property's largest expense, typically accounting for somewhere between 50% and 60% of the total operating expenses for the property. So, for example, if a property has \$1,000,000 in operating expenses, staffing is likely to account for \$500,000 - \$600,000 of that total.

However, finding and retaining qualified staff is a real challenge for Senior Housing properties and the costs seem to go ever higher so it is important that operators do their best to keep this expense line item under control as best they can.

### Meals and Housekeeping

One of the most basic services that a Senior Housing property offers is meals and housekeeping. Residents typically get three (3) meals a day and their apartments cleaned on a regular basis. For operators, both services come with an input cost - food and staff for meal services and cleaning staff for housekeeping. The services may be performed by property staff or outsourced to a third party vendor. Either way, there is a cost, which is typically 10%–15% of total operating expenses, depending on quality of services. So, if a property has \$1,000,000 in total operating expenses, meals and housekeeping may account for \$100,000 - \$150,000 of that total.

### Maintenance and Utilities

Obviously there is a significant amount of upkeep that comes with maintaining a multifamily property. From minor things like trash pickup and floor cleaning to big ticket items like maintaining the air handling systems, boilers, and electrical panels. Maintenance is a near constant effort.

Likewise, the utilities payment arrangement can have a significant impact on the operating cost of a Senior Housing property. Unlike a typically multifamily apartment complex, the units in a Senior Housing facility are typically not individually metered. As such, the cost of utilities is typically included in the base rental price for residents or it is allocated to residents as an additional expense on top of their rent. In either case, the operator must pay the utilities for the property.

Combined, maintenance and utilities typically account for 8% - 12% of total operating expenses, although the figure is likely to be higher for older properties. So, continuing the example, a property with \$1,000,000 in total operating expenses, is likely to have \$80,000 - \$120,000 in the maintenance and utilities line items.

### Insurance and Compliance

As I discussed in the “Risks” section, operators must be prepared not only for the potential for financial loss due to damage to a property (from a storm for example), but also from the risk of financial loss due to trips and falls as well as negligence. As a result, a Senior Housing property required a number of different types of insurance - like liability, property, and workers compensation.

In addition, depending on the location, Senior Housing facilities are often required to comply with a series of state and/or local rules and regulations. These could include things like complying with minimum staffing level requirements or things like fencing or emergency exit lighting requirements.

For both insurance and regulatory compliance, there is an expense that is typically 5% - 8% of total operating expenses. So, if a property had \$1,000,000 in total operating expenses, investors should expect to see \$50,000 - \$80,000 for the insurance and compliance line item.

### *Net Operating Income, Debt Service, and Cash Available for Distributions*

A property’s Total Income minus its total operating expenses results in a metric known as “Net Operating Income” - which is critically important for a property’s valuation and its ability to make the required loan payments (if there are any).

From Net Operating Income, there are typically two major line items that are deducted. The first is any “reserves” that are to be set aside for future big ticket expenses. Again, these could be things like repainting the entire property, replacing all air handling units, or replacing the roof. The second is the required loan payments. Most properties are purchased with a loan, but not always. So, if there is no loan, investors don’t have to worry about this piece.

So, continuing our example, assume that a property has \$2,700,000 in total income and \$1,000,000 in operating expenses, the total Net Operating Income is \$1,700,000.

From this amount, assume that \$700,000 was set aside in reserve for future big ticket expenses and another \$500,000 was paid in debt service. This leaves \$500,000 in cash left over that could be potentially distributed to investors.

### *Profitability Drivers to Understand*

Now that we know a little bit about the income and expenses for a typical property, it is important to understand what drives key changes in these metrics. For potential investors, there are a number of key factors to consider when evaluating a potential investment in a Senior Housing property:

- **Occupancy:** A property’s occupancy directly translates into revenue. Ideally, every property stays 100% full all the time. However, in reality this is not likely to be the case. So, it is

important for investors to understand what historical occupancy levels are for a property/market and what the operator is doing to ensure they always stay high.

- **Premium Services:** Upselling care services and amenities boosts revenue per resident. As such, it is in operators best interest to do so. For investors, carefully review what premium services a property offers and how they boost total revenue.
- **Cost Containment:** Managing costs in a Senior Housing property can be a tricky proposition. On one hand, operators want them to be as low as possible to maximize profit. On the other hand, operators must take a long term view that prioritizes resident safety, satisfaction, and security - as such, they can't cut too many expenses. There is a balance here and investors should ensure that expenses are reasonable and necessary, but not excessive.
- **Lease Up / Rental Growth:** For new properties, investors should look for a very consistent leasing trajectory to give comfort that the property will ultimately reach full occupancy. Once a property has achieved stabilized occupancy, investors should look for a clear rental growth trajectory that, at the very least, keeps pace with expense growth. Ideally rental growth exceeds expense growth.
- **Market Factors:** Independent of an operator's efficiency, there may be certain market factors that impact a property's profitability. On one hand, growing markets could see rental growth that exceeds the national average. Or on the other hand, a shrinking market could struggle to keep units full without significant rental concessions. For this reason, investors should seek out properties in strong, stable markets with a healthy supply/demand profile.

For investors, it is important to understand both the income/expense profile of a given property as well as the drivers of a property's success and how they contribute to the overall return.

### *Understanding Total Returns*

We now know how income and expenses work, what Net Operating Income is, and how different factors impact total profitability. Given this, the last thing I want to discuss in this chapter is total returns from a Senior Housing investment. Typically there are two major components.

#### Recurring Cash Flow

The first component of Senior Housing investment returns is recurring cash flow - which refers to the periodic distributions provided to investors that is driven by the profitable operations of the property. However it may not always be this easy as there are two types of cash flow that a property could produce:

- **Stabilized Cash Flow:** This comes from mature, "stable" properties that have a long operating history and strong occupancy figures. Typically, these properties are fully leased and the distributions are steady, if not consistently growing.
- **Lease-Up Cash Flow:** This is typically associated with new properties that are still in the process of leasing units to residents. The risk is higher for these property types, but potential returns can be 20–30% higher than stabilized assets.

In most cases, recurring cash flow makes up a small, but stable, part of the total return. The bulk of the return typically comes from growth in the value of the investors initial equity.

## Equity Growth

Equity growth refers to the growth in the value of the initial investment and it typically makes up the bulk of returns and is typically earned over the long term (5-10 years). One of the beautiful things about an investment in Senior Housing is that there are three ways that equity can grow:

- (1) **Loan Amortization:** Most of the time, a Senior Housing property is purchased with a combination of equity (investor funds) and debt (the loan from the bank). If the loan obtained is an amortizing loan, meaning that payment consists of principal and interest monthly, then each payment is going to reduce the overall loan balance.

For example, assume that a \$1,000,000 property is purchased with \$250,000 in equity and \$750,000 in debt. Now assume that the first payment is \$25,000, of which \$5,000 goes to interest and \$20,000 goes to principal. At the end of the first month, the building is still worth \$1,000,000, but now the loan balance is \$730,000, which means that investor equity is worth \$270,000 - the value increased. Another way to think about this is, by using property cash flow to reduce debt, investors' equity will grow - assuming an amortizing loan.

- (2) **Net Operating Income Improvements:** As I described earlier, Senior Housing properties are valued based on the amount of Net Operating Income they produce, using a technique called "Direct Capitalization" - where the Net Operating Income is divided by a Capitalization Rate. For example, suppose that a property has \$150,000 in Net Operating Income and the Capitalization Rate is 7.5%, this means that the property value could be estimated to be \$2,000,000.

Now, suppose that the operator is able to implement changes at the property - such as charging for Ancillary Services or reducing costs (or both) - that results in increased Net Operating Income of \$175,000. At the same 7.5% Capitalization Rate, the property is now worth \$2,300,000. Or, put another way, at a 7.5% Capitalization Rate, every additional \$1 in Net Operating Income adds \$13.33 in value to the property.

- (3) **Strong Market / Cap Rate Compression:** Finally, the last way equity can increase in value is that a strong market can drive values up through "cap rate compression."

A property's Capitalization Rate is a rough estimate of its annual return. If a market is strong and investors believe that cash flow is going to be stable and consistent, one investor might be willing to accept a lower return to gain access to that market. This is manifested by purchasing the property at a lower cap rate. Let me explain with an example.

Suppose a property produces \$150,000 in Net Operating Income and the Capitalization Rate is 7.5% - we've already established that this property is worth \$2,000,000. Now suppose that investors like the prospects of this market and they are rushing in to acquire properties. Due to demand, market Capitalization Rates have fallen to 6.75%. This means that the value of the property - without any changes to its operating profile - is now worth \$2,200,000.

In the most ideal scenario, investors get all three types of equity growth - loan balances going down, improving Net Operating Income, and market values going up. By the time a property reaches year 5 or 10, the difference can be significant.

Going back to our earlier example, assume that a property was purchased for \$1,000,000 and it was funded with \$250,000 in equity and \$750,000 in debt. Now, by year 7 of owning the property, investors have been fortunate to get all three types of equity growth. The result is a property whose value has increased to \$2,000,000 and a loan whose balance has fallen to \$600,000. The difference is now \$1,400,000 - or the original equity amount has grown by 5.6x the original amount - a home run for investors.

## Final Thoughts

The economics of senior housing are fairly straightforward.

All properties produce income through rental, care services, and ancillary services.

This income is used to fund a property's operating expenses, which include things like staffing, meals and housekeeping, maintenance, utilities, insurance, and compliance. The difference between income and expenses is known as Net Operating Income - which is a key valuation metric.

Key drivers of Net Operating Income - and thus profitability - include occupancy, offering of premium services, cost containment, rental growth, and independent market factors.

Total returns for senior housing come from a combination of recurring cash flow and equity growth, combined they can provide a significant profit over the long term.

Given these factors, and what we know about the coming Silver Tsunami, the economic case for Senior Housing is clear - these are properties that stand a very good chance of staying full over the long term, thus delivering strong returns to investors.

If you agree with this thesis, let's talk about *how* to invest in Senior Housing properties.

## How to Invest in Senior Housing

In the previous sections, I've done my best to make the case for why investing in Senior Housing is a good idea. In this section, I am going to lay out a five step process for actually making an investment:

1. Identify your risk tolerance and time horizon
2. Choose an investment strategy
3. Select an asset class
4. Select an Investment Vehicle
5. Complete due diligence

For each one of these steps, I am going to provide a significant amount of detail so that potential real estate investors have all of the information needed to make the best decision for themselves and their level of risk tolerance.

## Step 1: Identify Your Risk Tolerance and Time Horizon

Every investor is different. They have different needs, different return objectives, different market preferences, and different risk tolerances. So, for this reason, the first step in the real estate investment process is to identify two key pieces of information - your risk tolerance and time horizon.

### *Risk Tolerance*

In every investment, risk and return are highly correlated. The higher the risk, the higher (and more volatile) the potential return. Conversely, the lower the risk, the lower (and more stable) the return. With this in mind, I think we could all agree that the ideal investment is the one that provides the highest possible return with the least possible risk. But, everyone may have a different tolerance for risk. To understand your own risk tolerance, it can be helpful to ask yourself a few questions:

- How much variability am I willing to accept in my returns?
- Am I OK with one or more years of negative returns while waiting for positive returns to emerge?
- How long am I willing to wait to realize cash flows from my investment? E.g. Investing in a new Senior Housing property means that investors could have to wait one or more years before they ever receive a dividend whereas investing in an existing, stabilized, property could generate cash returns right away.
- What is my primary return objective, growth or income (e.g. cash flow)?
- If I lost 25% or more of my investment in a given year, how would I feel?

In general, new Senior Housing developments, properties in secondary or tertiary markets, and Class C & D properties tend to be at the higher end of the risk spectrum. On the other hand, Class A & B Senior Housing properties, and assets in major cities tend to be at the lower end of the risk spectrum.

So, before choosing which Senior Housing investment you want to make, it is important to identify your own risk tolerance as a way of narrowing your potential investment choices. It can be easiest to describe it as low, medium, or high.

### *Time Horizon*

The other major thing to ask yourself is - what is my time horizon for this investment?

In general, the best real estate returns are made over the long term. So, the longer an investor's time horizon, the higher the potential return. But, this may also mean tying up money for an extended period of time with no access to it. For example, there are many Senior Housing investments that require a 10 year commitment before an investor is eligible to receive their principal investment back.

Again, it is important to identify your own time horizon as a way of narrowing down your list of suitable real estate investments. Those with short time horizons (less than 5 years) may lean towards more liquid investments like publicly traded Senior Housing REITs. Whereas, those with long term horizons (5+ years) may lean towards direct purchases or the types of syndications that we offer. We'll talk more about what these exact asset classes are in a little bit.

### *Summary and Conclusion*

The very first step in making a real estate investment is for each investor to take the time to think about their own goals and objectives - particularly their risk tolerance and time horizon because doing so will go a long way in helping each individual narrow down the most suitable Senior Housing investment opportunities.

## Step 2: Choose an Investment Strategy

In general, there are two types of Senior Housing real estate investment strategies, active and passive. We could also call them direct and indirect. Again, the choice here will help to identify the most suitable investment opportunities for each individual. Let's talk about each of these strategies in detail.

### *Active Investment*

An active investment strategy is exactly what it sounds like - it is one where an investor is actively involved in every aspect of the Senior Housing investment. This means that they are responsible for finding the property, analyzing it, arranging the financing, closing on the purchase, and, perhaps most importantly, for managing the day to day operation of the property once they own it. For a large scale Senior Housing investment, this can be a full time job.

There are two major benefits to an active investment strategy - control and returns. Active investors have control over every aspect of the investment and management process, which may appeal to those who like to be involved. Active investors also get to keep 100% of the returns generated by the property.

However, there are also two potential drawbacks to an active investment strategy - time and risk. As I mentioned above, managing an investment grade Senior Housing property can be incredibly time consuming. And, from a risk standpoint, active investors may get to reap 100% of the benefits, but they are also responsible for 100% of the risk - meaning that they are going to be the first person called in the event of a fire or flood or that may need to shoulder significant losses of the investment does not go according to plan.

Those who prefer an active investment strategy tend to form their own investment companies to purchase and manage their properties directly.

### *Passive Investment*

A passive investment strategy is the opposite of an active one. With it, an investor takes a passive role in the ownership and management of the property, choosing to outsource it to another person or company in return for a share of the profits. For example, buying shares in a REIT or in a private syndication reflects a passive approach to Senior Housing investment.

The primary benefit to a passive approach is time - as in a passive investor gets all of the benefits of investing in Senior Housing (income, appreciation, taxes, etc) without the time commitment of finding, financing, and managing a property directly. In addition, passive investors may benefit from the expertise and deal flow of their deal leaders in a passive investment.

The primary downside to a passive approach is control. Because passive investors outsource the work of finding, financing, and managing an investment, they also give up control over property decisions. In addition, passive investors have to give up a share of the profits to their deal leader in return for all of their work.

### *Summary & Conclusion*

Both the active and passive real estate investment strategies have their benefits and drawbacks. One is not necessarily better than the other but, one may be more suitable than the other given an investor's risk tolerance, time horizon, and desire to be actively involved in the day to day operation of the property.

While every individual is different, busy individuals/professionals are likely going to be a better fit for a passive investment strategy than an active one.

### Step 3: Choose a Senior Housing Investment Type

This step is perhaps the most difficult and the most personal of the five I will outline in this book. Once you have identified your risk tolerance/time horizon and chosen your investment strategy, the next step is to choose what type of Senior Housing you want to invest in. In general, there are three options (NOTE: Each of the property types described earlier could fall into any one of the below categories):

- **Fully Stabilized Assets:** A fully stabilized asset is one that is complete and filled with rent-paying residents. Often they have several years of operating history that can be analyzed to provide investors with comfort that the property will continue to perform as it has in the past.

The primary benefit of a fully stabilized asset is confidence. Because it is fully stabilized, investors can feel confident that they will achieve a stable, consistent return from day 1 (e.g. less risk). Other benefits include consistent, reliable cash flow as well as high occupancy and slow, but steady, growth. The primary downside is price and return. Because the property is fully stabilized, it is likely to be far more expensive than those that are not. As a result, it means that returns for these properties are likely to be lower - although more stable.

- **Leaseup / Turnkey Development:** In terms of risk, the next step up from a fully stabilized asset is one that has some amount of lease up risk, meaning that construction for the property is either almost finished or recently finished and is in the “lease up” phase. The lease up phase is the period of time, usually 12-18 months, between when construction for the property is completed and it has reached full occupancy. During the lease up phase, the operator is actively marketing the property to prospective residents and working to get them to sign leases.

The reason that the lease up phase is slightly more risky is that there may be some amount of variation between the projected lease amounts and the actual lease amount. For example, suppose that the operator projected that they could lease a unit for \$3,000 per month, but were only able to sign a lease for \$2,750 per month. If this happens across multiple units, the net result would be lower than projected cash flow and returns. However, it can also work the other way, which is when units lease for more than projected, meaning cash flow and returns could be higher than expected.

The key benefit of investing in a lease up property is that the potential return could be higher - perhaps significantly so. The downside is that there is far less certainty, which means that the return is also less certain - it could be higher or lower than projected.

- **Development / Redevelopment:** Finally, perhaps the riskiest option is a property that is planned as a new development or one with a major renovation or redevelopment planned. Because these projects may take years to complete, market conditions can change significantly from start to finish, which means that the actual performance could turn out to be far different than the original plan.

The major benefit of a development project is the reward can be significant. If the market moves in the right direction during the construction phase, and actual rents turn out to be far higher than expected, the return can be significant. But, the risk is that the market could also turn against investors and rents could turn out to be far lower than expected - the property could suffer through any range of outcomes from lower than expected returns to additional capital injections required or foreclosure by the lender.

So, when considering which type of Senior Housing to invest in, the key question for an investor to ask themselves is, “how much risk am I comfortable with?” To help make the decision, use the following table:

<b>Investment Type</b>	<b>Risk Level</b>	<b>Cash Flow Timing</b>	<b>Upside</b>	<b>Investor Profile</b>
Stabilized Assets	Low	Immediate	Moderate	Prefer conservative, predictable returns
Lease Up / Turnkey	Medium	Delayed (12 - 24 Months)	High	Comfortable with short-term risk, seeks equity growth
Development / Redevelopment	High	Delayed (24+ Months)	Very High	Aggressive, willing to tolerate construction and lease up risk

## Step 4: Select an Investment Vehicle

Ok, so at this point, you have determined your risk tolerance and time horizon, chosen an investment strategy (active v. passive), and selected a Senior Housing investment type. Now, it is time to choose *how* to invest in your selected investment type - it isn't as simple as just wiring money somewhere.

In this section, I am going to discuss the most common Senior Housing investment vehicles, including:

1. Direct Purchase
2. Partnership
3. REITs
4. Syndications

Like the previous section, I will explain what each one is, the pros and cons, and who it tends to be the best fit for. Let's start with Direct Purchase.

### **Vehicle #1: Direct Purchase**

#### *What is a Direct Purchase?*

A direct purchase is exactly what it sounds like. With it, an investor purchases a Senior Housing property directly in an application of an active investment strategy. For example, an investor could directly purchase a Senior Living facility as an investment property, either in their own name or in the name of an entity formed for the purchase.

#### *What are the Benefits of a Direct Purchase?*

Much like the active investment strategy, the primary benefit of a direct purchase is control. Because the investor owns the property directly, they have control over all aspects of it. They can choose the tenants, set the rental rates, determine which renovations to make, and decide when to sell the property.

In addition, direct purchasers get to reap 100% of the profits from the investment and don't have to worry about splitting them with partners or co-investors.

#### *What are the Downsides of a Direct Purchase?*

There are three downsides to a direct purchase that I want potential investors to be aware of.

First, direct purchasers bear all of the risk in the property. If the property burns down in a fire, washes away in a flood, or becomes vacant due to mismanagement, the fallout rests squarely upon the direct purchaser.

Second, because a direct purchaser owns the property, they are responsible for managing it. This can be both incredibly time consuming and requires a significant amount of expertise - especially for the Skilled Nursing and Memory Care property types.

Finally, Senior Housing can be incredibly expensive. Choosing to purchase a property directly limits investors to what that can afford on their own, which could lead to diversification issues. For example, if an investor has \$1,000,000 to invest and uses all of it to a single facility, it will not likely be an investment grade property and they have used all of their available funds to purchase just one property.

#### *Who is the Best Fit for a Direct Purchase?*

A direct purchase vehicle is the best fit for investors that prefer an active investment strategy and those with the time, capital, and/or expertise to manage the property effectively.

### **Vehicle #2: Partnership**

#### *What is a Partnership?*

In a partnership, one or more investors may come together to purchase a property (directly). Often, the partners will go through the process of creating a “partnership agreement” that outlines the roles and responsibilities of each partner and their share of property costs and profits.

#### *What are the Benefits of a Partnership?*

The primary benefit of a partnership is that, by pooling funds together, investors can purchase larger and higher quality properties together than they could on their own. In addition, a partnership spreads the risk among all partners, and may be able to generate more income given the larger size of the properties that can be purchased.

#### *What are the Downsides of a Partnership?*

The primary downsides to a partnership are the complications that come with trying to get others to agree on major decisions. For example, if one partner thinks that the group should sell the property, but the other disagrees, the situation is ripe for conflict. In addition, partners with different levels of financial resources could result in a variety of negative situations. For example, suppose that a property needs a significant renovation and the partners need to contribute \$100,000 each to do it - one partner has it and the other doesn't. This is another scenario that is ripe for disagreement.

#### *Who is the Best Fit for a Partnership?*

Partnerships tend to be the best fit for experienced investors who understand how to navigate the pitfalls of a partnership and those who are OK taking an active decision making role in the management of the property.

### **Vehicle #3: REITs**

#### *What are REITs?*

REIT is an acronym that stands for “Real Estate Investment Trust” and it is a specialized type of tax advantaged investment company that allows investors to purchase shares in an institutional grade portfolio of Senior Housing investment properties. REITs can be publicly traded or privately owned and they tend to specialize in certain property types. For example, Welltower is a large, prominent Senior Housing REIT.

### *What are the Benefits of Investing in a REIT?*

By rule, REITs are required to distribute at least 90% of their taxable income to shareholders in order to retain their tax advantaged status. As a result, REITs tend to have high dividends - which generate passive income - and can offer a great deal of diversification because investors purchase shares in a diversified portfolio of properties. In addition, publicly traded REITs are far more liquid than other investment vehicles allowing investors to buy and sell shares as needed with low transaction costs.

### *What are the Drawbacks of Investing in a REIT?*

REITs tend to have far higher fees than other asset classes (like stocks or bonds) and investors have no say in the day to day management of the property portfolio. In addition, publicly traded REIT prices are more exposed to the whims of public market movements, which can cause return variability based on factors outside of an investor's control.

### *Who Should Invest in REITs?*

REITs tend to be a good fit for investors with a low to moderate risk tolerance who prioritize income and liquidity over long term growth.

## **Vehicle #4: Syndications**

### *What is a Syndication?*

A syndication is a specialized type of partnership where investors pool their money together to buy a Senior Housing property that is larger and more expensive than any one of them could likely afford on their own. A Syndication differs from the partnership described above in that there are two "classes" of partners - the General Partner (GP) and a group of Limited Partners (LPs). The General Partner is the deal leader and they are responsible for finding, financing, and operating the property while the Limited Partners are passive investors who provide capital but otherwise have no say so in the day to day operation of the property.

### *What are the Benefits of Investing in a Syndication?*

A syndicated investment provides investors with all of the benefits of direct ownership - income and appreciation - without any of the hassle of actually managing the property (the General Partner does that). In addition, syndication investors often received a "preferred" return which means that any cash flow produced by the property goes to them first up to a certain level. For this reason, syndicated returns are often quite healthy.

### *What are the Downsides of Investing in a Syndication?*

There are four noteworthy downsides to a syndicated investment.

First, General Partners don't work for free, meaning that the fee structure in a syndication can eat into returns.

Second, syndicated investments can be illiquid because they are private investments with no secondary market. In fact, many syndication documents require that investors commit their capital for up to 5 or 10 years during which time they are unable to sell their shares.

Third, a syndication is a completely passive investment which means that individual investors have no say in the day to day property management decisions.

Finally, syndicated investments are only available to “Accredited” investors who meet certain income and/or net worth thresholds - \$250,000 in income and/or \$1MM in net worth. We at CREE capital can help you through this process.

#### *Who Should Invest in a Syndication?*

Syndications tend to be a good fit for investors who prefer passive income, meet accreditation criteria, and those who have the patience/ability to lock up their investment funds for 5-10 years.

#### *Summary & Conclusion*

There are many different “vehicles” through which an individual can invest in real estate, including a direct purchase, partnership, REITs, and syndicated investments. Each option has benefits and drawbacks so it is important for individual investors to recognize what they are and choose the option that is the best fit for their individual objectives and preferences.

### Step 5: Complete Your Due Diligence

To recap, by this point, you have identified your risk tolerance and time horizon, chosen an investment strategy, decided on a property type, and selected an investment vehicle. Before you make a final decision, there is one more thing you need to do - complete your due diligence on the property/investment. In this section, I am going to describe the four major types of due diligence that you should complete and I’m going to highlight some of the major red flags in a potential investment.

It is important to note that the due diligence process and complexity may vary slightly from one property to another. As such, I am going to describe Due Diligence in more general terms and encourage you to always take the extra step of looking into the details of your specific potential investment opportunity.

In general, it is a best practice for investors to conduct four types of due diligence on any potential Senior Housing investment - physical, financial, legal and operational. Let’s discuss each in more detail.

#### **Physical Due Diligence**

The goal of physical due diligence is to determine whether the physical condition of a given property or properties is sufficient to warrant investment.

Or, put another way, the goal of physical due diligence is to determine if a property has some type of deficiency that will require significant sums to fix - *before* investing in it. In a worst case scenario, an individual invests in a property only to find that it has mold or some type of surprise environmental issue that will cost a fortune to fix, resulting in a loss on the investment.

In order to ensure the physical condition of a property is adequate, potential investors should investigate the following items:

- Physical condition of the property - including major mechanical systems like HVAC, plumbing, and electrical
- Condition of the major structural components like the roof, foundation, and windows.
- Environmental condition of the property and its surroundings to ensure no major soil or water contamination
- Building licenses and permits to ensure that everything is in order

- Building plans and square footage to make sure they match the marketing materials
- Interior condition of the property to ensure it is not worn or dated. If it is, go one step further to understand any plans for potential renovations and the reasonableness of the budget

Again, the high level goal of physical due diligence is to inspect every square inch of the property to make sure that there are no major structural, foundational, or environmental issues. It is better to find out about these issues *before* you make an investment so you can plan for the time, disruption, and expense of remediating them.

Practically, in a passive investment scenario, it may be unlikely that you will be able to inspect the property yourself. Instead, you will likely have to rely on the reports from third party inspectors and there are three that you should pay special attention to, the Phase I Environmental Site Assessment, the appraisal, and the property inspection. These reports will contain all of the details about the physical condition of the property and can be relied upon in the absence of the opportunity to physically inspect the property with your own eyes.

## Financial Due Diligence

There are two goals of financial due diligence and you can think about them in terms of what has happened with the property in the past and what the plan is for the property going forward.

Regarding what has happened in the past, it is important to review the historical financial statements for the property to ensure it has performed as advertised. It may even be a good idea to take the extra step to compare the property's bank account statements to its financial statements to ensure they match. For example, if the financial statements say that the property had \$1,000,000 in revenue in a year, a potential investor should be able to see \$1,000,000 in deposits in the property's bank accounts for that same year.

In many ways, the plan for the future is the most important aspect of financial due diligence. To complete this part, it is important to review the following key documents and plans:

- **Rent Roll:** A property's rent roll is its roster of tenants and it provides key information like tenant name, lease start date, lease end date, and square footage leased. Investors should review this to ensure that income projections for the property are reasonable and to look for "tenant concentrations" which are tenants who lease an outsize portion of space in the property and who could blow a hole in the property's finances if/when they leave.
- **Proforma:** A property's proforma is a projection of its income and expenses over time. Its planned income should match what is on the rent roll and its planned expenses should be reasonable, producing enough operating income to comfortably make the required loan payments. If you are investing in a syndication or partnership, the proforma is probably created by your deal leader. If you are buying a property directly, it is up to you to create the proforma to model the property's potential returns.
- **Appraisal:** An appraisal is a third party report that provides an estimated value of the property. Perhaps more importantly, the appraiser also completes their own proforma for the property and it should be reasonably consistent with the one provided by the deal leader.
- **Capital Expenditure Plan:** "Value Add" Investors often purchase a property at a steep discount with the idea that they are going to execute a plan to invest significant sums into renovations or additions to improve the property. If this is the case in your considered investment, the plan should be reviewed carefully to ensure it is reasonable.

- **Financing Plan:** Most properties are purchased with some combination of debt and equity. In general, the debt on the property should not exceed ~75% of the property's value (lower is better) and should not include riskier loan types with variable interest rates or mezzanine lenders.

Again, the goal of financial due diligence is to ensure that the financial plan for the property is reasonable, consistent with market dynamics, and data driven with adequate evidence from past performance. If you are going to buy a property directly with an active investment strategy, you may have to do all of the financial due diligence on your own. If you are investing in a syndication or REIT with a passive strategy, the financial due diligence is likely completed for you by the deal leader, but it is still your job to check their work.

## Legal Due Diligence

The next type of due diligence I want to discuss is legal due diligence whose goal is to ensure that the property is being used for a legally permissible purpose and that there are no major title, leasing or existing litigation issues associated with the property. To complete legal due diligence, there are a number of key steps:

- **Review all leases:** Investors should review all property leases to make sure that there are no issues with allowable uses of the property and that tenants are in compliance with their lease requirements.
- **Title:** Investors should ensure that there is clear title to the property and that a title insurance policy is in place.
- **Existing Litigation:** Ideally, there is no existing litigation surrounding the property or its tenants. If there is, there should be a clear path to resolution.
- **Survey & Zoning:** There should be no issue with the property's current use and zoning requirements.
- **In Place Contracts:** An existing property likely has a dozen or more contracts with service providers like landscapers, property managers, utility providers, internet service providers, plumbers, electricians, and bookkeepers. Investors should review in place contracts to ensure that terms are fair and reasonable and to verify that there are no issues on either side with performance.
- **Loan Documents:** Investors should review loan documents, specifically to look for payment and covenant requirements to make sure that they are reasonable.
- **Operating & Syndication Agreements:** If you are going to invest in a syndication, it is important to review the Operating and Syndication Agreements to ensure that you are comfortable with the roles and responsibilities of all parties in the transaction.

Much like physical due diligence, the primary risk with legal due diligence is that there is some big issue that you only find about *after* you make the investment leading to some huge expense or financial judgement.

## Operational Due Diligence

If you are going to invest in a syndication or REIT, there is an added due diligence step that should be taken, which is to ensure that the individual or companies managing the property are well qualified for their duties.

The bullets below highlight some key topics that should be asked of the property manager(s):

- Experience and client list (want to make sure the property manager does not have any conflicts of interest)
- Fees
- Insurance
- In place policies and procedures

- Technology systems used
- Available reporting
- Reputation and reviews

For many tenants, especially in residential properties (like Senior Housing) the property management company is the face of the owner/investor so it is critically important that they do a good job and maintain strong relationships with tenants, vendors, and visitors.

### **Due Diligence Summary & Conclusion**

The last step prior to making an investment is to complete your due diligence, but this is not one to be skipped. It is critically important to examine all physical, financial, and legal aspects of the property/investment to ensure that there are no surprises. In general, unexpected surprises mean money to fix them, which is something that you want to do your best to avoid.

Once your due diligence is complete, you will arrive at the point where you have to make a decision - to invest or not. This is not a one size fits all decision, everyone is unique with their own preferred investment strategy, asset class, and investment vehicle.

For high earning, extremely busy professionals with a low to moderate risk tolerance and a long term time horizon, we believe that an investment in a Senior Housing syndication can provide the type of stability, consistency, and growth that is necessary to build financial security without any of the time and expertise requirements required when owning real estate directly.

For this reason, in the second half of this book, I am going to switch gears a bit and discuss Senior Housing syndication investment opportunities in much more detail. Specifically, I am going to discuss how syndications work, what their benefits are, the typical syndication structure, return splits, and how to evaluate a syndicator to ensure they are going to do a good job on behalf of their investors.

## **How Senior Housing Syndications Work**

In this section, I am going to describe how syndications work. Let's start with the basics by describing what one is in more detail.

### **What is a Syndication?**

A syndication is a real estate investment structure where investors pool their money together to purchase a large asset that would likely be out of reach for any of them individually. In a typical syndication, there are two groups of investors, General Partners (GP) and Limited Partners (LPs).

The General Partner is the deal leader. They are the investment firm who is in charge of finding the property, negotiating the purchase, raising the financing, and managing the day to day operations once the purchase is complete. Typically, the General Partner will contribute 5% - 10% of the upfront cash needed to purchase the asset, with the remainder coming from Limited Partners.

Limited Partners make up the “syndicate” and they are a group of individual, accredited, investors who each contribute a portion of the total equity needed. Often, the General Partner will set a minimum investment amount - like \$25,000 or \$50,000 - and when enough investors have contributed, the purchase is closed. It is important to note that, with their capital, investors are not actually purchasing a share of the property itself. They are purchasing shares in the company that owns the property (usually an LLC), which entitles them to their proportionate share of the income and profits produced by the underlying property.

To drive home the concept of a “syndicate”, an example is helpful.

Suppose that an investment firm, like ours, finds a Senior Housing property that appears to be a good investment opportunity. The property has a purchase price of \$10,000,000 and the investment firm has already arranged a loan for \$7,500,000, meaning that they have to raise the remaining \$2,500,000 from investors. To kick start the capital raise, they start with \$250,000 of their own money and then work with their investor network to raise the remaining funds.

Often, the funds have to be raised quickly, usually 60-90 days, and once they are, the deal can close. Once the purchase has been completed, the investment firm (the GP) runs(or hires a third party to run) the day to day operations of the property doing things like maintenance, collecting rent, landscaping, repairs, and signing new leases while investors take a passive role and collect their proportionate share of the income and profits produced by the property.

## **Benefits of a Syndication**

We’ve already discussed the benefits of a Senior Housing investment in general, but now let’s talk about the specific benefits of a syndication.

### *Benefit #1: Passive Income*

Again, the key benefit of a syndicated investment is passive income. The investment firm, sometimes called the Syndicator, handles all day to day operations of the property and simply distributes each investor’s share of the income on a monthly or quarterly basis.

So, for busy professionals who have a significant income, but not enough time to manage a property on their own, passive income may be a very attractive prospect.

### *Benefit #2: Networks and Expertise*

Through years of experience and dozens of deals, syndicators develop both expertise in Senior Housing investment and operations as well as a network of brokers, investors, property managers, and lenders to gain access to the most attractive deals that would typically be unavailable to individual investors.

In other words, investing with a syndicator (versus doing it individually) can provide busy professionals with access to deals they could not likely find on their own. In addition, a syndicator’s operational expertise means that they can likely run a Senior Housing property more efficiently and more profitably than an individual.

### *Benefit #3: Time*

As a general rule, the best Senior Housing profits are made over the long term. Because a syndication is a privately held investment, they are not subject to the whims and price changes of public markets, meaning that syndicators have the benefit of enough time to manage the property through various market cycles and sell it

when the conditions are just right. In a typical syndication, the planned holding period is between 5 and 10 years, but could be longer or shorter depending on market conditions and property performance.

## Syndication Risks to Consider

Like any investment, there are potential downsides to consider for a syndicated investment. I want to highlight three.

### *Risk #1: The Syndicator*

The performance of a syndicated investment is highly dependent upon the skill and expertise of the syndicator managing the deal. To mitigate this risk, investors should look for the following attributes in a Senior Housing syndicator:

- **Experience:** Investors should only work with syndicators who have a demonstrated, multi-year track record of successful, profitable deals. If there is any doubt, investors should ask syndicators for their credentials, prior deals, and history
- **Reputation:** Syndicators should have a strong reputation in the local market for being honest, easy to work with, and straightforward in all of their business dealings. Potential investors should carefully investigate a syndicator's reputation to ensure it is a good one.
- **Incentive Alignment:** Syndicators do not work for free - they are compensated through a combination of fees and a share of the income produced by the property. But, each deal structure can be a little bit different so it is important for investors to take the time to understand how the syndicator is compensated. In the best deals, the financial incentives of both the General Partner (e.g. the Syndicator) and the Limited Partners (e.g. the investors) are aligned so that they both benefit when the property is profitable.
- **Fees:** Again, Syndicators receive at least part of their compensation from fees, including asset management fees. Fees charged by a Syndicator are used to recoup some of their upfront investment to put together a deal and to finance the support structure required to operate a commercial grade Senior Housing property. While fees are perfectly normal, they ***should not*** be a profit center for the Syndicator. Investors considering multiple potential opportunities should carefully compare the fee structure to determine if any of them are excessive. However, it is important to note that lower fees do not always equate to a better deal. Top notch Syndicators may charge higher fees, but deliver the returns to make it worth it.

To summarize, any professional considering working with a Senior Housing Syndicator should carefully perform their own due diligence to ensure they are comfortable with the experience and expertise of their deal leader.

### *Risk #2: Control*

It is critically important for potential investors to ensure they understand that a Senior Housing syndication is a ***passive investment***. When they contribute capital, they also waive their ability to make day to day decisions about the operations of the property.

While many can see this as a benefit - because this work is outsourced to the Syndicator - some may see it as a risk. In any disagreement about a major property decision, like a sale or refinance, investors have no say in the ultimate outcome. If the disagreement rose to the level of a legal dispute, the Syndicator is likely to prevail because this is explicitly outlined in an investment's offering documents.

### *Risk #3: Capital Calls*

It is a common misconception that a Syndication is a one-time investment. While this may be true for some deals, it is not necessarily the case for all of them. There are some scenarios where the performance of a property or market conditions may result in something known as a “Capital Call,” which is a request from the Syndicator for more money. If an investor does not participate in a Capital Call, there is a risk that their interest in the deal can be “diluted” so that their share is not worth as much.

When determining the amount to invest in a Senior Housing syndication, investors should carefully consider the potential that they may have to inject additional capital somewhere down the line.

Just like every investment opportunity, individuals should carefully consider the risks and benefits of a Senior Housing syndication to ensure they are comfortable with them

## How Do Senior Housing Syndication Returns Work?

Splitting property returns is perhaps the most complicated - and important - part of understanding how a syndication works. In this section, I am going to explain it as simply as possible.

Based on the syndicated structure described in the previous section, we know that both the General Partner and Limited Partners are invested in the deal. So, it is logical to presume that they both want to see a return on their money.

In general, there are three ways that a Senior Housing property’s income and profits can be split between the General Partner and their Limited Partner(s): (1) A pro rata split; (2) a preferred return; and (3) a waterfall. Let’s discuss each one of these in detail.

### **Pro Rata Splits**

In a pro rata split, both the General Partner and the Limited Partners are entitled to their proportionate share of the income and profits produced by the underlying property. The math here can be complex, but let’s continue the simple example above to demonstrate how a pro rata split works.

In the example, the property had a purchase price of \$10,000,000, of which \$7,500,000 will come from a loan and \$2,500,000 comes from investor funds. Of the \$2,500,000, the General Partner invested \$250,000 of their own money (10% of the total needed) while the remaining \$2,250,000 was raised from investors (90%). Now assume that the LLC will issue 100 shares at a cost of \$25,000 each. The General Partner will get 10 shares while Limited Partners will get the remaining 90 shares.

Now assume that at the end of the first year of operation, the property produced a profit of \$100,000. If this is split on a pro rata basis, the General Partner is entitled to 10% or \$10,000 while the Limited Partners are entitled to the remaining \$90,000 or \$1,000 per share. This piece is split among the Limited Partners based on the number of shares that each of them own.

While this split scenario is relatively straightforward, it is rarely used in practice because the General Partner is not incentivized to maximize the property’s profitability.

### **Preferred Return**

In a Preferred Return scenario, investors receive a “preference” on the cash flow produced by the property, meaning that they are paid first and any money left over is subject to a predetermined split. For example,

investors may receive an 8% “Pref”, meaning that they get 100% of the income and profits produced by a property until they receive an 8% return on their investment. Anything left over is split between the General Partner and the Limited Partners on a predetermined basis - say 50/50.

For investors, the benefit of a Preferred Return scenario is that they get paid first. As such, the General Partner is incentivized to deliver a return that is more than the “Pref” because they will not receive anything otherwise. However, the drawback is that their upside is somewhat limited given they have to split everything over the “pref” with the GP. So, this can become very expensive.

A Preferred Return Scenario is certainly more common than a pro rata split, but still not the most common. That distinction belongs to the Waterfall split.

## **Waterfall**

A waterfall split is the most common structure for splitting cash flow in a Senior Housing syndication. These can become incredibly complex, but the simple explanation is that the share of income and profits for the General Partner is on a sliding scale based on the return they deliver for Limited Partners.

Remember in the example above, the General Partner contributed 10% of the total cash needed - meaning they own 10% of the shares in the LLC that owns the property - and the Limited Partners own the remaining 90%.

In a common waterfall scenario, there are three “tiers.” In the first tier, the property’s cash flow and profits are split pro rata until the Limited Partners earn a return of 6%. Anything above that would move to the second “tier” in which the cash flows are split with 20% going to the General Partner and 80% to the Limited Partners when the return is higher than 6%, but less than 12%. This extra 10% bonus to the General Partners is known as a “promote” and it is designed to provide an incentive to deliver stronger returns. If the return is higher than 12%, the General Partner may get another promote, meaning they get 30% of the income and profits while the Limited Partners get 70%.

The benefit here should be clear. In a waterfall structure, the General Partner is incentivized to deliver the highest return possible because that is also how they stand to earn the most money. If they succeed in delivering a high return, investors also benefit because they got a high return. This is a perfect example of the “incentive alignment” discussed earlier.

When it comes to the cash flow split between the General Partner and the Limited Partner(s), the key point is that potential investors should carefully evaluate the return split to ensure they are comfortable with it prior to committing capital to a deal. Details of the return splits are typically outlined in an investment’s offering documents like the Offering Memorandum, the Private Placement Memorandum, and the Operating Agreement. Each of these documents should be read carefully prior to making an investment. If there is any doubt, investors should consult an attorney to answer any questions they may have.

## **Should I Invest in a Senior Housing Syndication?**

So, here we are at the end of the book, and at the main point.

Up until now, I have discussed the benefits of investing in Senior Housing real estate, I’ve gone through the five step process for making an investment and I’ve gone into great detail about Senior Housing syndications,

including: how they work, and how a property's income and profits are split between a General Partner and their Limited Partner(s).

With all of this information, there is a question that I am hoping that you are asking yourself - should I invest in a Senior Housing syndication?

It can be very difficult to answer this question objectively because, as we've already established, every investor is different. Before committing capital to a Senior Housing syndication and making a final decision, investors should evaluate the following:

- **Risk Appetite:** While Senior Housing deals tend to fall at the lower end of the risk spectrum, the risk can certainly vary from one deal to the next. For example, a Class A property that is only 2 years old and is located in an affluent suburb of a major city has much less risk than a Class C property in an outlying area of a tier 3 or 4 city. In general, higher risk can mean potentially higher reward, but also significant variations in returns and potentially months or years before investors ever begin to receive distributions. Investors with a lower risk tolerance should stick to the highest quality properties with the best locations, most luxurious amenities, and highest occupancy levels.
- **Time Horizon:** Generally Senior Housing syndications have a planned holding period of 5-10 years, during which time investors cannot access their capital or sell their shares, except under extenuating circumstances. Even then, they are likely to be forced to sell at a significant discount to their book value. Senior Housing syndications may not be a suitable fit for investors who cannot afford to have their capital locked away for this time period.
- **Return Expectations:** Risk and return are highly correlated. The higher the risk, the higher the *potential* return. The lower the risk, the lower, but more stable, the potential return. In other words, it is unrealistic to expect that an investment is going to have little risk, but high potential return. Investors should carefully consider their return expectations, especially relative to other options (like stocks or bonds) and ensure their deal is appropriate for it.
- **Total Portfolio:** The bedrock principle of a sound risk management strategy for investing is diversification and we consistently preach that real estate should be just one asset class in a diversified investment portfolio. As such, investors should carefully consider the size of their total investment portfolio and only allocate a small portion of it to Senior Housing syndications. For example, if an investor had a total portfolio of \$50,000, it would likely be unwise to dedicate \$25,000 of that to a Senior Housing investment.
- **Control:** Remember, a Senior Housing syndication is a passive investment. For investors who desire more control over the day to day operations of the property, a syndication is not likely to be a good fit for their preferences.

Given these factors, the question for potential investors is not "should I invest in a Senior Housing syndication" but "is a Senior Housing syndication suitable given my personal circumstances and preferences?" The answer to the second question varies by individual and can only be answered by the investor.

## What Does Good Look Like?

Finally, if you do decide that you want to invest in a syndication, whether it is with us or someone else, I want to leave you with a general profile of what a "good" deal looks like. Remember, the definition of "good" can vary by investor, but I have provided a general outline below for a number of important deal characteristics:

- **Debt:** As a general rule, there is a sweet spot for debt that is somewhere in the range of 60% - 75% of the purchase price. In addition, the debt should have a fixed interest rate and a term that is commensurate with the planned holding period for the investment (e.g. 5-10 years).

In addition, the strongest deals generally do not include other types of riskier debt such as mezzanine loans, bridge loans, or interest only loans.

- **Proforma Assumptions:** In order to construct a five or ten year Senior Housing proforma, it is necessary to make a number of assumptions about what is going to happen. These assumptions can have a major impact on the projected return. They should be reasonable and data driven. Here are a few assumptions to pay special attention to and the general best practices for them:

- **Rent Growth:** It is reasonable and customary to assume 2% - 3% rent growth per year for the duration of the planned holding period. Anything more than this may be a little bit too aggressive.

I will note that there is a common investment strategy known as “value add” in which a property is purchased and renovated. In value add investments, it is normal to see a rental jump of more than 2% - 3% when the renovations are complete and rents are adjusted to reflect that.

- **Expense Growth:** Expense growth should also be in the 2% - 3% range, preferably less than the rent growth - you don’t want expenses to grow faster than income.
- **Vacancy:** Even if the property is 100% full, a reasonable proforma should still assume a vacancy allowance of 5% - 7% annually. Anything significantly more or less than this should have a strong justification.
- **Total Operating Expenses:** As we’ve discussed, operating expenses are the costs associated with running a property and they include things like property taxes, insurance, and maintenance.

For *senior housing* properties, total operating expenses should be in the range of 60% - 70% of the projected income. So, if projected income is \$1,000,000, total proforma expenses should be in the \$600,000 - \$700,000 range. They are higher because senior housing properties usually have more support staff to care for residents.

- **Sales Price:** This one can require some math, but investors should compare the purchase price for the property to the assumed sales price at the end of the investment period to derive the implied annual appreciation rate. If it is more than 5% or 6% per year, it is likely overly optimistic
- **CapEx Reserves:** Syndicators should set aside approximately \$250 - \$300 per year, per unit for future repairs.
- **Market Comparison:** Rental rates should be in line with the market. More importantly, if the syndicator plans to complete renovations the increased rental rate should not be at the tip top of the market.
- **Fees:** Every syndicator charges fees, but they should not be excessive. They should be just enough to cover the expenses associated with starting the entity and managing the property. If you feel they might be excessive, it is a red flag and you should ask how they compare to other syndicators in the same market.
- **Entry/Exit Cap Rates:** A property’s cap rate is a metric that is used to express the relationship between its price and its net operating income (NOI). It is calculated as  $NOI/Price$ . So, for example if a property has NOI of \$100,000 and a purchase price of \$1,000,000, the resulting cap rate is 10%. The Cap Rate roughly approximates the annual return on the property.

The “Entry” cap rate is calculated when the property is purchased and the “Exit” cap rate is calculated at the time of sale.

For *senior living properties*, strong deals have entry cap rates in the 7% - 9% range with exit cap rates in the 9.5% - 10.5% range.

It is important to note that these are just ranges and exceptions are certainly possible, but they should be supported with data and a strong justification. The “Offering Memo” for a potential deal should have a “Proforma Notes” page that details the assumptions described above. You can find them there.

- **Operating Team:** As I mentioned above, the Operating Team, sometimes called the Syndication Team, can really make or break a deal because they are solely responsible for finding, financing, and managing the property on behalf of their investors. For those considering a syndicated investment, there are a number of key things to look for in the Operating Team:
  - **Reputation:** If you are going to trust someone with your hard earned money, they should have a sterling reputation.

Look up your syndicator on the internet, the better business bureau, ask friends and colleagues, and network with other investors. If you have any questions or hear any doubts about the reputation of your syndicator, ask them about it. If you don't get a straight answer, it could indicate potential issues down the road.
  - **Experience:** The Operating Team should have years of experience with the specific property type (e.g. apartments and senior housing) and a demonstrable track record of successful transactions.
  - **Approach:** The Syndication Team should have a conservative approach to the transaction and understand that they are the stewards of other people's money.
  - **Communication:** The Syndication Team should have excellent communication with their investors, in both good times and bad. They should provide regular reports and updates so there is never any doubt about the status of the investment.
  - **Property Manager:** Under certain circumstances, the Operating Team will choose a property management firm to run the property on a day to day basis. The property management firm should have all of the same characteristics described above - they should have a good reputation, plenty of experience, and a conservative approach. They should also be incredibly responsive to residents to make sure they are happy. For many residents, the property manager is the face of the investment so they must be chosen wisely.
  - **Fees & Income Splits:** As we discussed further, the fees charged by the Operating Team should be reasonable and consistent with other firms doing similar deals. Fees should not be a source of profit; they should be just enough to cover reasonable and customary expenses. In addition, the waterfall income splits should demonstrate clear incentive alignment between the Operating Team and their investors - when they win, everyone wins. The following bullets highlight some of the fees to look out for and their general amount (**NOTE:** The type and amount of the fee likely varies from deal to deal - the below figures are just estimates):
    - **Acquisition Fee:** The acquisition fee is charged on the amount of the purchase price and can range from 1% to 2% of the deal size.
    - **Start Up/Organizational Fee:** Putting together a real estate deal requires a lot of effort and a syndicator may charge a start up fee to cover the cost of things like the legal,

accounting, marketing, and technology work required to get the investment up and running. Typically, the fee will range from .5% to 2% of the total equity raised.

- **Debt Placement Fee:** When debt is used to finance a deal, an outside broker may be used to obtain it. If this is the case, it is normal for a fee to be paid for their services. On occasion, the syndicator may choose to layer an extra fee on top of the broker fee known as the debt placement fee. Combined (broker + manager), the fee may range from 0% to 1.5%.
- **Investment Management Fee:** To pay for the operations and management of the investment, syndicators may levy a fee of 1% to 2% of invested equity.
- **Refinancing Fee:** For assets that need repairs and/or renovations, it is common to obtain a short term loan to fund these costs and to refinance the asset once stabilized. Because it takes time and effort to line up a permanent loan, a manager may charge a fee for their efforts. It is normal for the fee to range from .25% to 1%.
- **Selling Fees:** When it comes time to sell a project, it is common for a manager to partner with a broker who has the capability and network to get the best price for the property. For their services, the broker may charge from 1% - 3%, but some managers may try to add .25% to .75% on top of it.
- **Joint Venture Fees:** Often, especially for larger deals, managers may team up to purchase a property by creating a joint venture. In some cases, both managers may charge a fee meaning that the investor has to pay both of them. To avoid this, the bulk of joint venture fees should be paid to the manager doing the majority of the work.

To make it a bit easier for you to evaluate an operating team, look in the [Appendix](#) for a list of questions to ask a potential sponsor

- **Returns:** Be wary of any Operating Team who promises exorbitant returns. There are three return metrics that you should pay attention to:
  - **Internal Rate of Return (IRR):** The Internal Rate of Return is a commonly used metric that roughly approximates the annual return on a property. It is also the metric used to set waterfall hurdles as described above. In general, strong deals offer an IRR of 15% - 20%. Anything significantly above or below this range should result in some questions for the Operating Team.
  - **Cash on Cash Return:** The Cash on Cash Return is another return metric that represents the return on actual cash invested. For example, if you invest \$100,000 and you receive \$7,500 in a given year, your cash on cash return is 7.5%. Strong deals offer cash on cash returns somewhere in the 4% - 8% range annually. Again, anything substantially above or below this range should result in some questions for the Operating Team.
  - **Equity Multiple:** Finally, the Equity Multiple is a metric used to describe the total cash return relative to the total cash invested. So, for example if you invest \$100,000 in a deal and receive \$200,000 back over the life of the transaction, the Equity Multiple is 2.0X. Strong deals have Equity Multiples above 2.0x. Anything over 3.0x is likely overly optimistic.

Again, it is important to stress that every deal is unique. Some deals may offer higher annual cash on cash returns while it may be lower for others, with primary reliance on a high sale price

to boost the overall return. The strongest deals have a good mix of a good cash on cash return *and* a profitable sales price that contributes to the overall return.

- **Timeline:** Finally, I mentioned it before, but the best real estate returns are made over the long term. The strongest deals have a total timeline of 5-10 years, which is normal and customary. Anything significantly below this, especially those promising high returns in a short period, should result in some questions for the Operator.

To be clear, every deal is unique and has its pros and cons. It is up to individual investors to review all aspects of the deal to determine if it is a good fit for their own objectives.

## Why You Should Consider Investing With Us

If you have read everything that precedes this section and have decided that a Senior Housing syndicated investment is a good fit for your needs and return objectives, there is no doubt that you have many syndicators to choose from. In this section, I'm going to make the case for investing with us in two parts - first, I'll discuss our company, CREE Capital, and then I'll discuss the benefits of investing with us.

### About CREE Capital

CREE Capital is a multifamily/Senior Housing investment firm and, at the time of writing, we manage an investment portfolio of ~3,700 units and \$450M. As the Chief Investment Officer of the firm, I have more than 20 years of real estate investment experience. In addition, I'm also the host of the #1 commercial real estate investing podcast - "Lifetime Cash Flow" - which has more than 17 million downloads, I'm the founder of the Rod Khleif Multifamily Investing Facebook group which has more than 48,000 members, and I am also the founder of Multifamily Mastery, an elite investing group, where I have trained, coached, and mentored thousands of investors.

Combined, with my cofounders, we have more than 97 years of multifamily investment experience and look forward to many more.

### What Makes Investing with CREE Capital Different?

At CREE Capital, we know that you want to build a financial future you can count on. The problem is that underperforming mutual funds and stock market volatility make this nearly impossible. This unexpected investment volatility can create a rollercoaster of anxiety when it comes to your money and your future.

You don't have to take on a ton of risk to generate rewarding returns. You deserve stable investments that are designed to perform, regardless of economic conditions. That's why we created a unique firm with proven investment opportunities to help you secure a better financial future.

Whether you're brand new to investing, or you're an experienced investor looking for skilled operators, you're in the right place!

### What is Our Investing Approach?

We follow a time tested investing approach to identify the most profitable investment opportunities and manage them through to a successful exit. Key steps in our approach include:

- 1) **We Locate and Acquire the Property.** Our regional Acquisition Specialists identify properties in markets that exhibit: a diverse and growing job base, positive population growth, favorable rent to home

cost ratios, and a landlord friendly environment. Once we've identified suitable properties, we perform exhaustive and careful due diligence on the property/market and create a detailed, conservative plan that generates attractive returns for our limited partner investors.

- 2) **We add Value & Reposition the Property.** We buy properties that have good fundamentals (location, style, amenities) but have been starved of capital or mismanaged. Using return on capital calculations per our detailed plan, we make interior/exterior upgrades to make the property more appealing to higher rent paying tenants. Over time, the property and net operating income increase which benefits our limited partners in two ways: growing monthly cash payments and a substantial capital gain opportunity down the road.
- 3) **We create tax benefits for our investors.** Once we've stabilized the property, we typically perform a cost segregation study in the first year and pass along substantial depreciation losses via a K1 to investors and we incorporate bonus depreciation wherever possible. With this strategy, your capital can grow quicker with reduced tax liability.
- 4) **We return maximum invested capital.** If it makes sense after we have increased the property value, we will refinance and return the proceeds to the limited partners. This enhances the ROI and allows LPs to redeploy the capital to new opportunities
- 5) **We carefully manage the asset and cash flow.** Our asset management team works tirelessly to continually improve the property which increases revenue and reduces the turnover costs associated with unhappy tenants
- 6) **We sell the asset.** Our goal is to maximize the total return from our investment and will continually monitor the market to determine the best time to sell the asset

### **As a Professional, Why Should You Invest with CREE Capital?**

There are three reasons why you, as a busy Professional, should invest with CREE Capital:

1. **We create value.** As I described above, Senior Housing is the easiest real estate asset class to create value for professionals. Value is created by economics (supply and demand), debt (leverage), and forced appreciation. We maximize returns by optimizing all three.

Specifically, we create value by: (1) acquiring the right assets, in the right markets, at the right price; (2) structuring the financing for our properties in a way that is both conservative (e.g. low debt) and flexible (e.g. waterfall structure); and (3) by spending funds targeted directly at specific items that will increase revenue. This is our special sauce that has been honed through decades of experience and hundreds of transactions.

In general, real estate tends to appreciate at a rate of 3-5% per year. With good leverage we can increase that to 7 to 9% but through forced appreciation we can sometimes see returns upwards of 20%.

In senior living the value add is dependent on the quality of care, which takes a tremendous amount of time and is not for the passive investor. Often, it requires a full-time staff that partners with real estate professionals to achieve returns of 25% or more.

2. **We do it for you.** As a professional, you are busy and do not have time to repair buildings. From property identification to financing, closing, and day to day property management, we manage every part of the investment for you. This provides you with the time to focus on what you do best, while benefiting from our focus on what we do best.
3. **We are driven by a spirit of service.** We understand that you have spent years, decades even, training to become an expert in your field, resulting in earnings that are high enough to qualify as an Accredited Investor. We also understand that, by investing with us, you are placing a tremendous amount of trust in our ability to be a good steward of your investment capital. We take this responsibility extremely seriously and manage all of our investments with a spirit of service towards all of our investors.

## How Do I Get Started?

If you have determined that a Multifamily Syndication is a suitable fit for your needs, we would be thrilled to work with you!

Setup a call to talk with our team - <https://creecapital.com/contact/>