ORIGIN INVESTMENTS

THE COMPREHENSIVE GUIDE TO INVESTING IN PRIVATE REAL ESTATE

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Principal and Co-founder

INTRODUCTION

Private real estate is an important part of a diversified investment portfolio, but is still a complicated and unfamiliar asset class for many investors. This guide provides a blueprint to everything the accredited investor needs to know when considering investing in private real estate. First, we explain the basics — how private real estate benefits portfolios, the most common real estate investing strategies and how much of a portfolio should be in private real estate.

Then, we help investors move beyond glossy real estate brochures to ensure a potential real estate investment is aligned with their personal tolerance for risk and backed by a feasible business plan. We detail the types of risk encountered in private real estate investments, the most common forecasting metrics, and the fees managers collect during the complex, multiyear investing process.

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PRIVATE REAL ESTATE BENEFITS

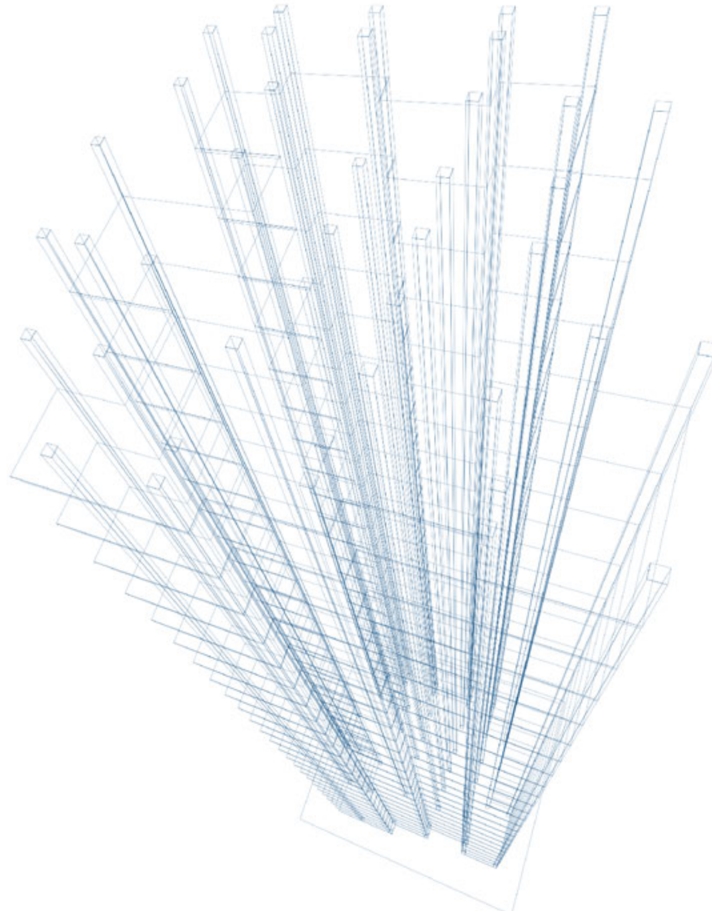
Private equity real estate investing is direct ownership of physical real estate — whether it's in the form of land, office buildings, rental homes, apartments, shopping centers, hotels, self-storage facilities and so on — with the intent of making a profit. Ownership means an equity stake in a piece of property. Individuals can invest in private real estate by acquiring assets actively as a direct buyer, or by investing passively with a private real estate investment firm, an online platform and/or in a non-traded private REIT.

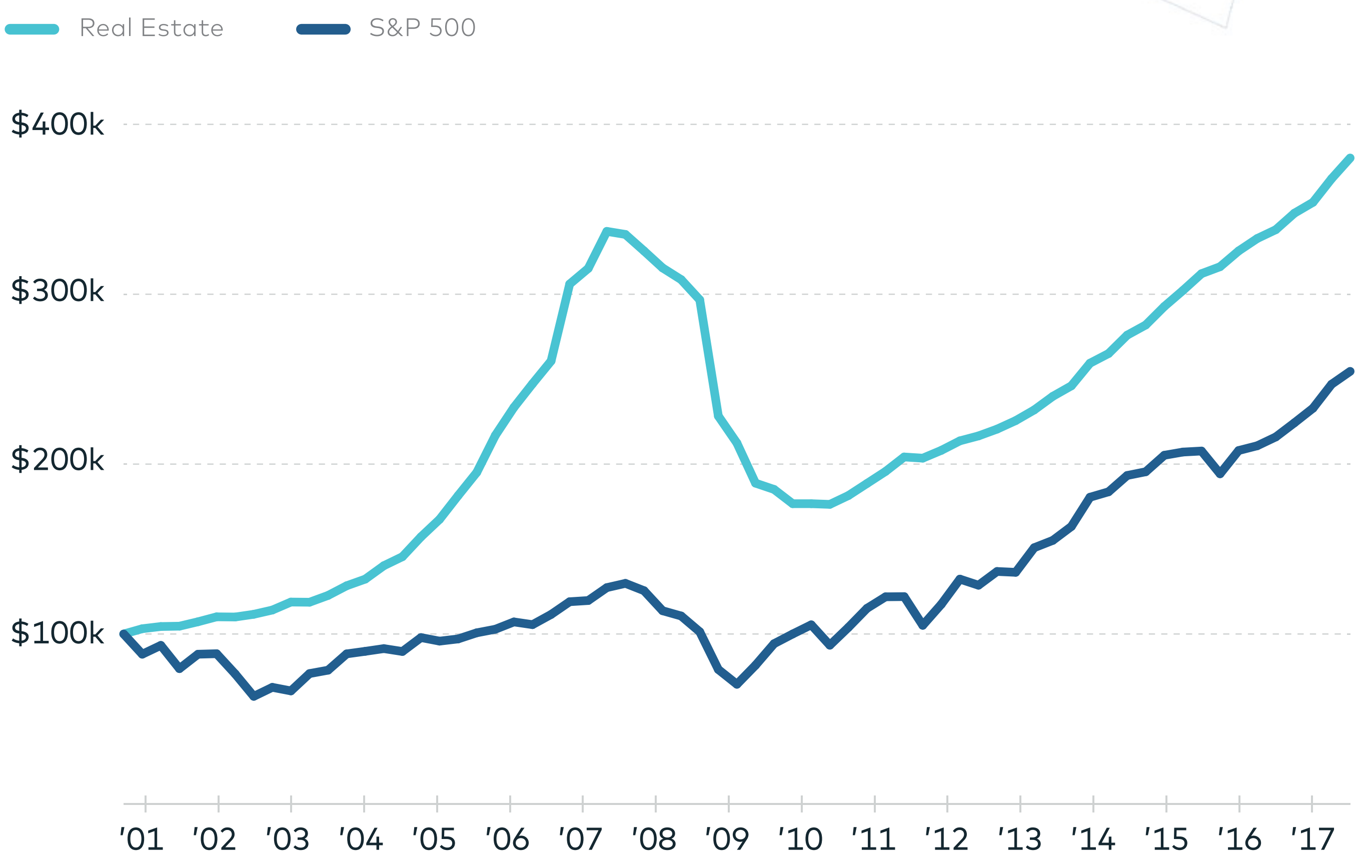
Private real estate offers many benefits to individual investors, such as high returns, portfolio diversification and tax efficiency. Institutional investors have long understood the merits of this asset class and relied on it in their portfolios to balance market uncertainty. Take Yale's endowment — considered the gold standard for its exceptional performance; **10% of its investment portfolio is allocated to real estate**. Not surprisingly, most endowments and pension funds follow a similar investment plan. But individual investors have only begun catching on to this strategy and started **adding private real estate to their portfolios in the last few years**.

> Yale's endowment, considered the gold standard for its exceptional performance, allocates 10% of the $27 billion of assets in its investment portfolio to real estate.

BENEFIT #1: PRIVATE REAL ESTATE GENERATES HIGH ABSOLUTE RETURNS

Private real estate offers investors the ability to generate high absolute returns. An absolute return takes into account appreciation, depreciation and cash flows to measure the amount of money an investment earns over time, and is expressed as a percentage gain or loss on the initial investment. Looking at data from Preqin, a research company that tracks the performance of alternative investments, a $100,000 investment in private real estate beginning on January 1, 2001, would have been worth about $380,000 on March 1, 2017. That same $100,000 investment in the S&P 500 would be worth $255,000 on March 1, 2017, as depicted in the chart below.





(* Preqin data)

BENEFIT #2: PRIVATE REAL ESTATE HAS LOW CORRELATION TO OTHER ASSET CLASSES

The goal of every portfolio is to create the highest total return with the least amount of volatility. Most investors are comfortable with a mix of stocks and bonds in their investment portfolios — until the markets' ups and downs start making them nervous. Private real estate helps investors temper the volatility in their portfolios because it's immune to the daily shocks of trading.

The value of a private real estate fund is based on the actual value of property held by the fund. Conversely, in a public REIT, the share price value is determined by daily market forces, which means the share price of a public REIT may not reflect the actual value of the underlying real estate. In some cases, the share price can value the REIT 30% higher or lower than the actual value of the underlying real estate.

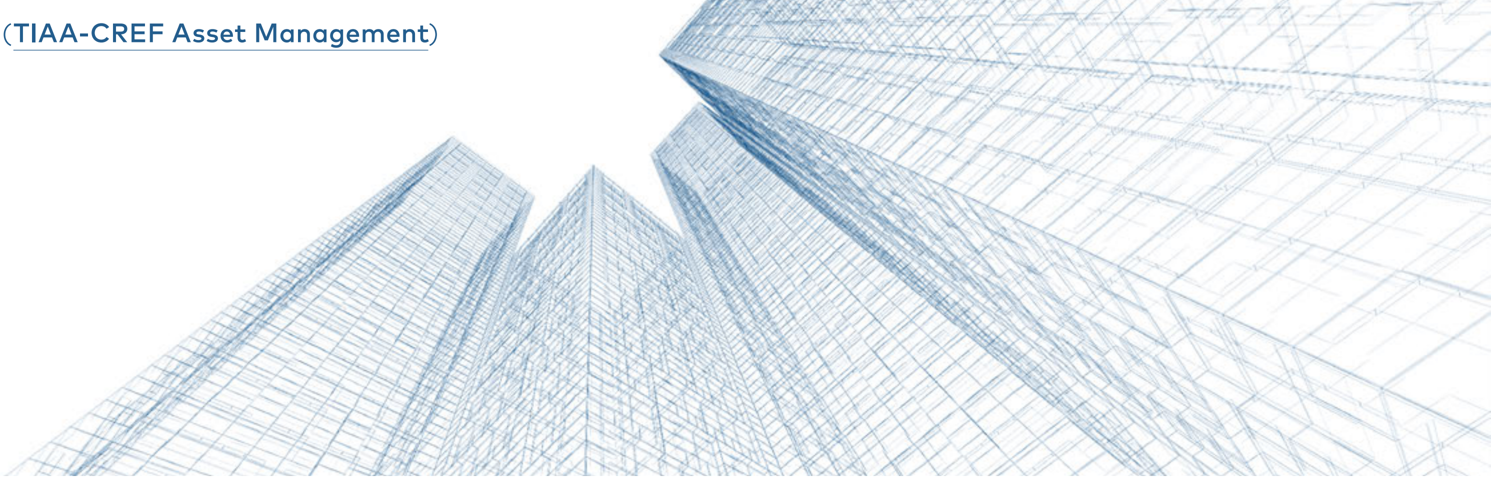
Private real estate values don't move much on a daily basis but rather appreciate slowly over time, which is why private investments are less volatile than their public counterparts. Both vehicles have pros and cons and the optimal portfolio has a combination of both. Public markets offer liquidity, but that comes at the expense of volatility and private investments offer investors low volatility, but with that comes illiquidity.

The chart below illustrates how private real estate has minimal correlation to stocks, bonds and even public REITs, as measured by the National Council of Real Estate Investment Fiduciaries (NCREIF) property index (NPI), which looks at the returns of private institutional grade commercial properties.

A correlation coefficient of 0 means that price fluctuations are not correlated at all. A correlation coefficient of 1 means that assets move together in tandem and a negative correlation means that they move in opposite directions to one another. An investment portfolio benefits greatly when it includes asset classes that are not correlated to each other.

	RUSSELL 3000	BARCLAYS U.S. AGGREGATE	NAREIT
NCREIF Real Estate	0.23	-0.24	0.13

(TIAA-CREF Asset Management)



BENEFIT #3: PRIVATE REAL ESTATE IS TAX EFFICIENT

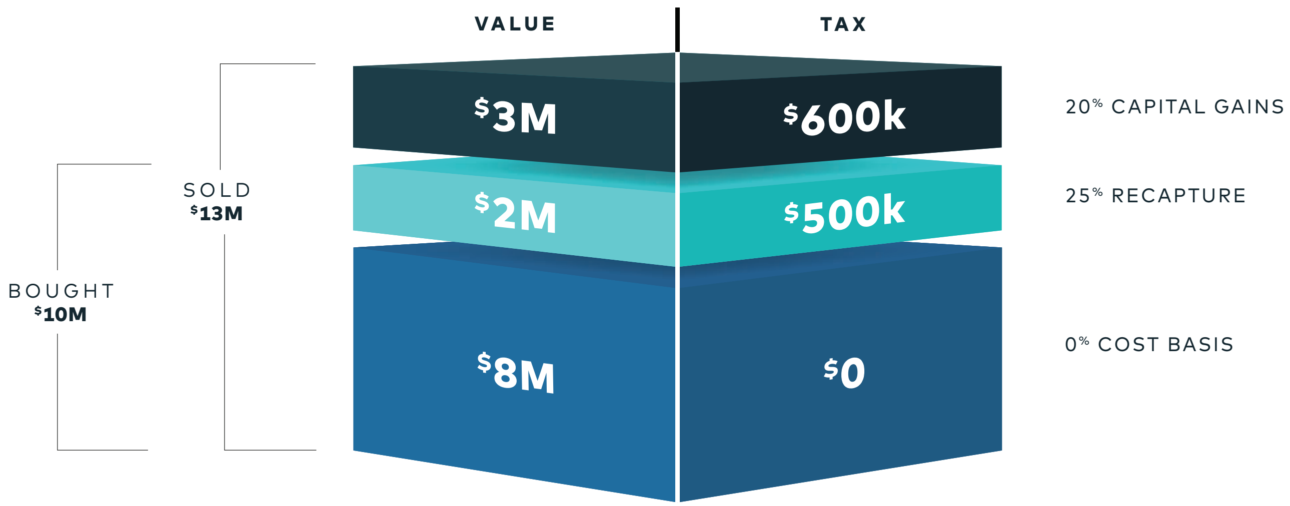
Investors who focus solely on an investment's underlying returns and ignore its after-tax yields don't recognize a big benefit of real estate investing. Income generated by properties is generally shielded **through depreciation**, providing investors with the long-term benefits of substantial cash flow and very little tax burden.

IRS rules allow owners to take annual losses in the form of depreciation to smooth out eventual capital expenditures as buildings age. However, only the physical elements of a property are subject to depreciation. Land can't be depreciated, and must be separated from the physical property value. For example, a multi-family property can be straight line depreciated over 27.5 years. If the property was acquired for $6 million and sitting on land worth $1 million, it will produce $181,818 in annual **non-cash depreciation**. This is calculated by dividing $5 million by 27.5 to yield $181,818.

In general, individuals will pay between 20% and 25% in taxes on real estate investments versus 37%, the highest tax bracket on ordinary income, for hedge funds and other alternative vehicles. So if a property generates $100,000 of cash flow and $50,000 in depreciation, then the taxable income to the individual will only be $50,000. The tax liability, assuming an investor is in the highest federal tax bracket, is calculated by .37 x $50,000 to yield $18,500, which is the equivalent of an 18.5% tax rate on the entire cash flow of $100,000.

However, the depreciated portion of the property is subject to a **recapture rate** of 25% upon sale. Here's how it is applied: if a property were acquired for $10 million and depreciated by $2 million, the **cost basis** for tax purposes would only be $8 million. The difference between the cost basis and the original purchase price is taxed at the recapture rate upon sale.

Additionally, any investment appreciation above the original purchase price, assuming the property has been held for more than one year, will be subject to the long-term capital gains rate of only 20%. Expanding on the example above, if the property were sold for $13 million, the difference of $2 million from the IRS tax basis of $8 million to the purchase basis of $10 million would be subject to the recapture rate of 25%. The gain from $10 million to $13 million would be taxed at the capital gains rate of 20%. The effective overall tax liability at sale would be $500,000 + $600,000, or $1.1 million. The diagram below details how this works.



Another tax benefit of real estate is the ability to defer taxes indefinitely through a 1031 exchange. The **1031 exchange** tax provision allows real estate owners to sell a property and buy another property without incurring capital gains taxes. In theory, an investor could buy and sell properties without ever paying taxes on the gains. The ability to defer taxes into the future is one of the greatest attributes of owning real estate directly.

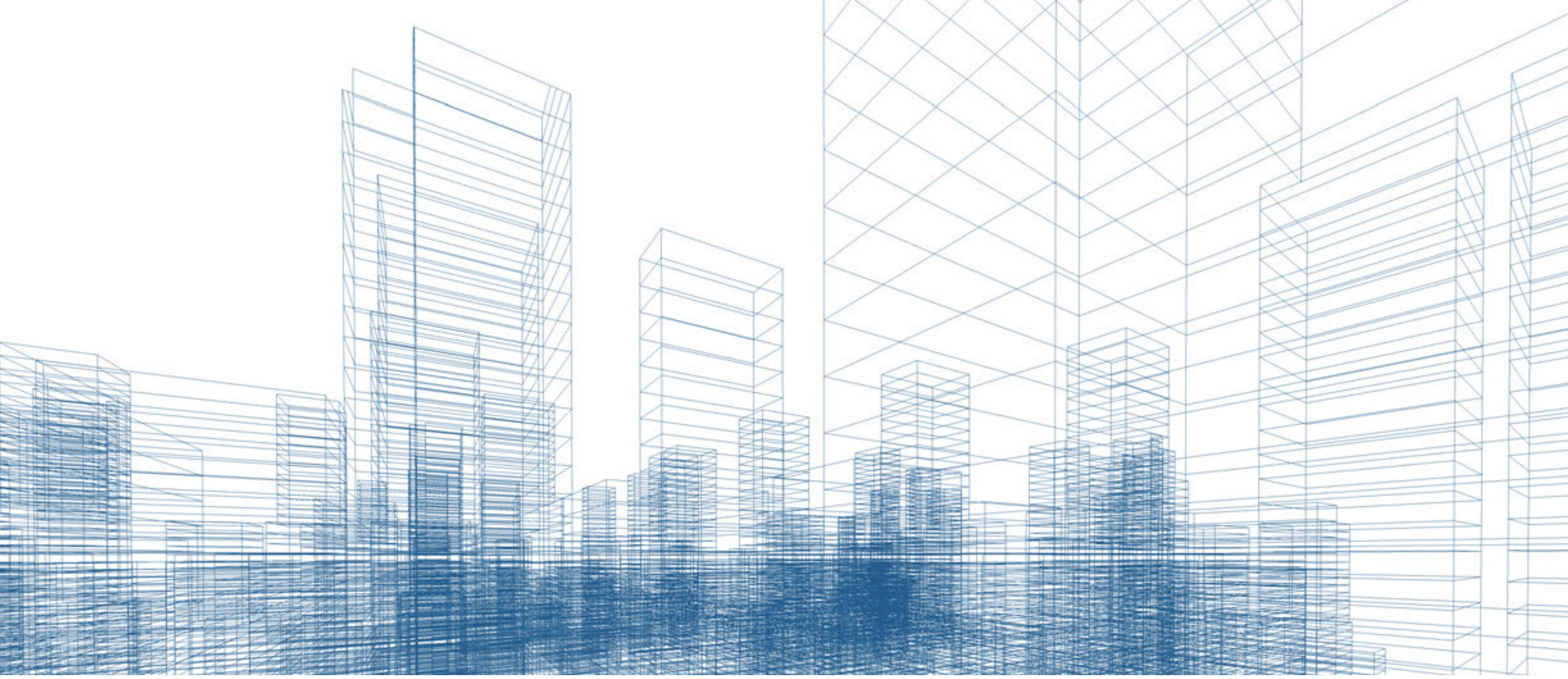
Finally, because private equity real estate is typically held in an LLC, which is considered a pass-through entity by the IRS, 100% of income, losses and expenses pass through to the owners. Unlike corporations, where owners may be subject to **double taxation** (the corporation pays taxes on corporate net income and the owner pays on any dividend income they receive), the LLC itself does not get taxed. Instead, individual members are taxed on their share of the income, expenses and losses reported on their **year-end tax document, the K-1**. They are taxed at their tax rate, which is often lower than the corporation's.

ACTIVE VS. PASSIVE INVESTING

Active investing is when buyers own and operate an asset outright, either by themselves, or with family, friends or acquaintances. They can make swift decisions and take advantage of opportunistic ventures because usually they are making decisions alone or with a limited number of partners. However, given the substantial capital and expertise required to acquire and operate investment-grade commercial real estate, there are high barriers to entry for buyers.

Acquiring property alone isn't impossible, but along with this option comes a lot of work and responsibility. The investor or owners will need to source the property, negotiate the price, obtain financing, collect rent, handle repairs and maintenance and manage the daily activities, from garbage disposal to renting vacant units. These responsibilities are amplified when making the multiple investments needed to build a diversified portfolio of properties — especially when further capital is necessary for tenant improvements, leasing commissions and renovation costs.

Unfortunately, in many cases investors don't have the necessary expertise and unwittingly buy real estate assets that require more time, resources, renovation and maintenance than originally expected. They may not have developed the right business plan to make the investment profitable, or have focused on too few assets to build a diverse real estate portfolio. Or they may be exposed to unlimited risk through liability and debt guarantees.



Passive investing is when an investor chooses to outsource their real estate investments to a manager, and pays them a portion of the profits for their services. Managers pool money from numerous investors to buy larger or whole portfolios of properties, and run all of the day-to-day operations for these assets. They acquire the properties, execute the business plans and report to investors. In this case, individuals are still direct owners in the underlying properties and receive all of the benefits.

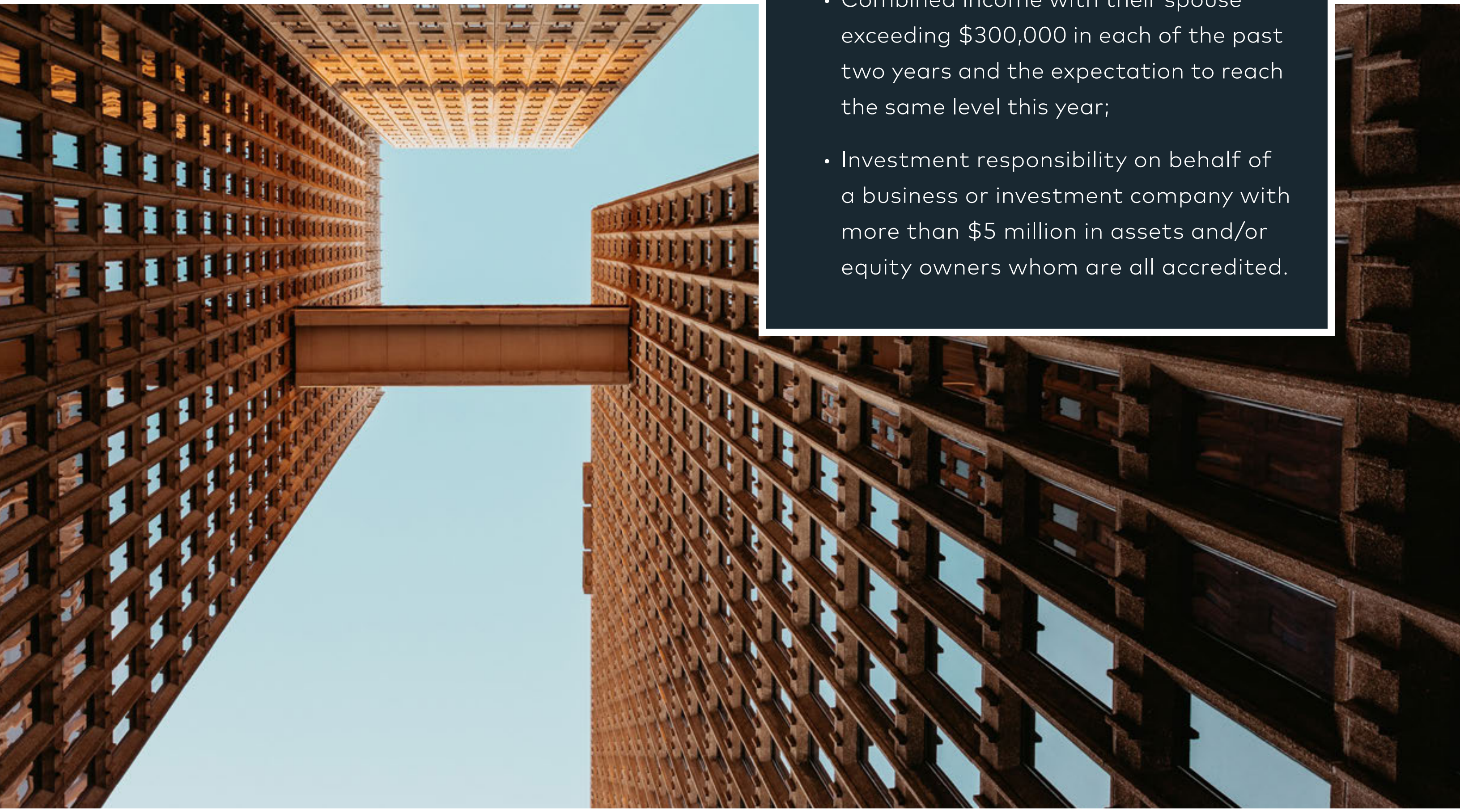
There are several different types of companies that offer passive real estate investing opportunities. Investors can choose a private equity real estate firm, an online crowdfunding platform or a non-traded private REIT. With these options, the real estate is typically held in a Limited Liability Company (LLC), which protects investors from the potential unlimited liability associated with owning a physical asset in the event of a lawsuit or some other unforeseen event.

WHO CAN INVEST IN PRIVATE REAL ESTATE?

Generally, private real estate investing is only available to accredited investors, a regulation set by the federal government. However, some managers utilize a Reg A+ vehicle that allows non-accredited investors to participate in private real estate for as little as $500.

Individuals meeting one of the following criteria qualify as accredited investors:

- Individual net worth, or joint net worth with their spouse, that exceeds $1 million (excluding the value of their primary residence);
- Individual income exceeding $200,000 in each of the past two years and the expectation to reach the same level this year;
- Combined income with their spouse exceeding $300,000 in each of the past two years and the expectation to reach the same level this year;
- Investment responsibility on behalf of a business or investment company with more than $5 million in assets and/or equity owners whom are all accredited.



REAL ESTATE STRATEGIES AND RISK LEVELS

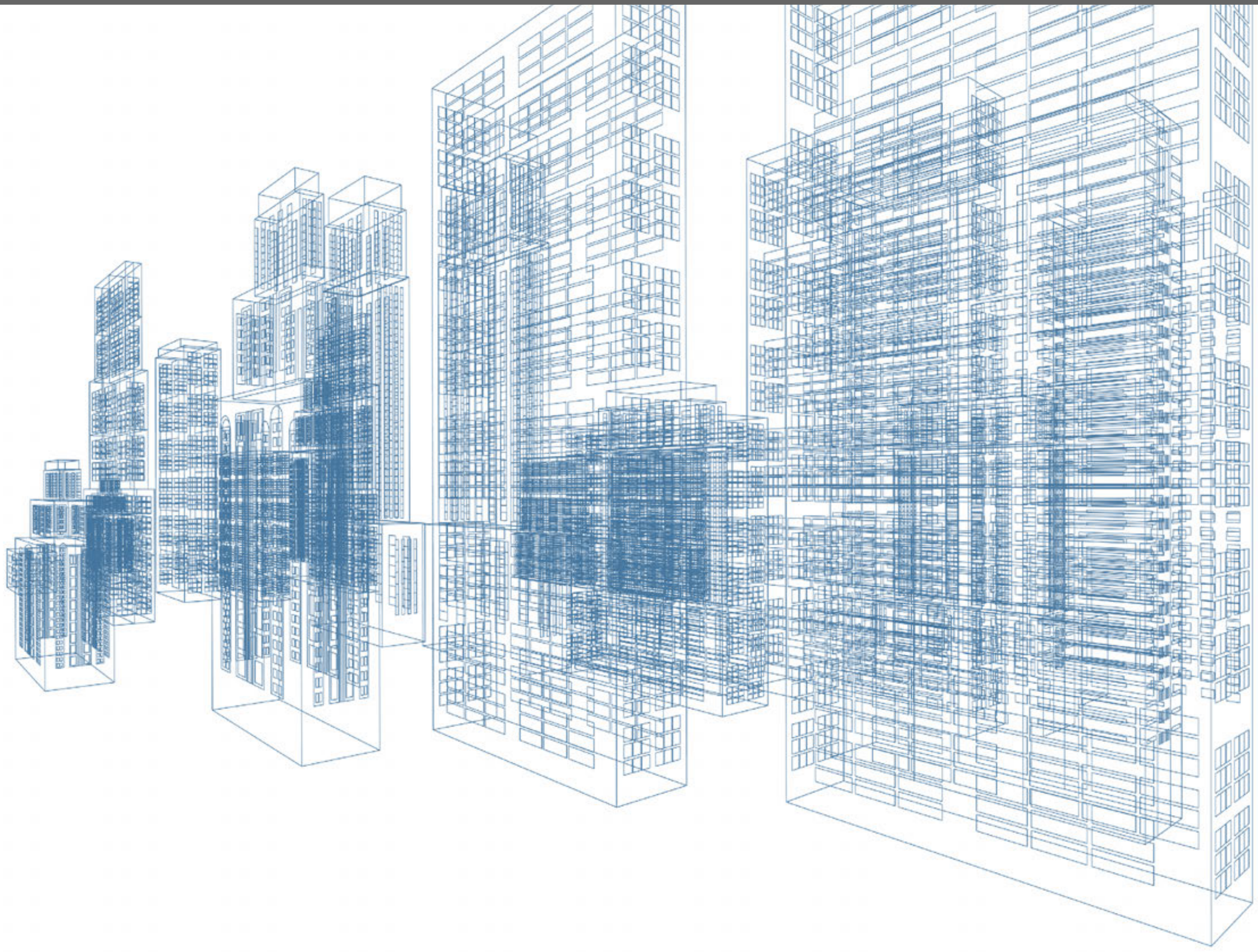
Private real estate investors should consider the level of risk they're willing to take to achieve their investment goals, and how long they are willing to wait before they begin receiving returns. Some investors may focus completely on long-term gains that have promising yields but little to no liquidity, while others may want to generate steady income that will offer more frequent dividends.

To achieve these investor goals, real estate operators focus on four main types of real estate strategies: Core, Core Plus, Value Add and Opportunistic. Each fall at a different point on the risk vs. return spectrum and require different types of leverage, since debt has a direct **impact on the level of risk an investor faces**. The risk of each type of investment and its relationship to leverage is explained in the chart below.

CORE	Core investments are considered the least risky because they involve stable, income-producing properties that are in prime locations in major markets; have no structural issues; and enjoy full or high occupancy with high credit tenants on long-term leases. These are Class A properties with steady income streams. For a landlord, what's not to like? However, thanks to their desirability, these types of investments warrant low leverage — typically between 30% and 50% — and are a perfect fit in a blue-chip portfolio that delivers a steady stream of income. The role of these core assets is to behave like a high-yield bond with little downside risk to principal. Typical returns in this sector are around 6–8% annually. The offset to this stability is that these types of investments generally do not offer much potential for growth.
CORE PLUS	Core-Plus investments are held for both income and growth, and while they are similar to Core properties, they have more potential for upside appreciation. For instance, a property may have a high proportion of leases up for renewal. While Core investors see this as a threat to steady income, Core-Plus investors might see this as an opportunity to increase rents and increase yield. Returns for Core-Plus are around net 9–12% annually and they are typically leveraged between 40–65%.
VALUE ADD	Value Add holds the middle ground between conservative Core and high-risk Opportunistic investments. Investors looking to take on more risk to achieve high returns, and are willing to defer gains, should invest in either Value Add or Opportunistic properties, which may require improvements and require more complex business models to achieve higher returns. Nearly all of the Value Add investor's return will come in the form of appreciation, with no expectation of cash flow for at least 24–36 months. Value Add properties may have operational issues and require physical improvements due to a prior owner's neglect, or need improvements that a prior owner lacked the capital to make. Value Add investments have the potential to be more lucrative than Core or Core-Plus strategies with the right kind of physical upgrades, better management, added services or more effective marketing. The targeted returns for a Value Add property average 13% to 18% annually, and they are typically leveraged between 60–75%.
OPPORTUNISTIC	Opportunistic investments are on the far end of the risk spectrum, and cover the broadest range of properties. These deals can involve buildings that require massive turnarounds of an existing property, adaptive reuse or even new ground-up development. The unifying strategy is that investors are willing to take outsized risks and put in higher upfront costs to achieve outsized returns. Ironically, Opportunistic new construction projects might eventually deliver Core properties that attract high-profile tenants. However, getting there takes years of labor, management-intensive development work and substantial market risk before the first rent checks roll in. Given these risk characteristics, there is typically a very high return threshold to meet before an investor should consider making Opportunistic investments. For instance, these investments are typically leveraged 70% or more, though they can generate returns in excess of 20% — if they are successful!

The matrix below helps guide investors on which type of private real estate investments may make the most sense, based on risk tolerance and time horizon.

TIME HORIZON	RISK TOLERANCE		
	CONSERVATIVE	MODERATE	AGGRESSIVE
0–5 YEARS	Core	Core	Core Plus
5–10 YEARS	Core	Core Plus	Opportunistic/Value Add
10–20 YEARS	Core Plus	Core Plus/Value Add	Opportunistic/Value Add



PORTFOLIO ALLOCATION GUIDELINES

How much of the investor's portfolio should be in private real estate? The old saying "don't put all your eggs in one basket" applies to real estate, as well as markets. Private real estate is cyclical in nature and goes up and down over time just like stocks and bonds, but not on a daily basis. For that reason, it is called illiquid, which means an investor's capital may take months or years to unlock, so it is not an option for those who need that capital in the short-term for living expenses or college tuitions.

However, that hasn't stopped investors from buying into this lucrative asset class. A Tiger 21 survey **cited by Bloomberg** showed that high-net-worth investors representing $51 billion in assets had an average of 33% of their portfolios in private real estate investments. But the ideal allocation truly depends on each Individual's situation, which is a combination of their net worth and time horizon.

For example, a family office worth $300 million may be fine with more than 50% of their investable capital in illiquid assets, while an accredited investor with $1 million in investable capital may not feel comfortable having any capital in illiquid assets. On the flipside, an investor may be perfectly comfortable with a large illiquid position in their retirement account, but not in their personal savings account, which they may need to tap into at a moment's notice. Illiquidity is something that has to be managed appropriately. The question to ask is how much liquidity should be reserved for an emergency?

The illiquidity that comes from private real estate investing isn't necessarily a bad thing, as long as an investor has enough savings to use for emergencies. One of the most common bad investing decisions is precipitated by panic when the market turns south. The pain of a stock market crash is so great that investors flee at the bottom, which is precisely the time they should stick with it.

Solid evidence substantiates this point. In "Why Smart People Make Big Money Mistakes and How to Correct Them," co-authors Gary Belsky and Thomas Gilovich pointed out that "by pulling your money out in short-term stock market drops, you run the risk of missing the productive days." And those productive days add up. They did the math: "If you missed the 90 best-performing days of the stock market from 1963 to 2004, your average annual return would have dropped from almost 11%... to slightly more than 3%."

It turns out that amounts to big bucks. According to the co-authors' calculations," on a $1,000 investment, those different rates of return translate into the difference between having $74,000 after four decades and having about $3,200." It brings to mind another benefit of real estate investment: illiquidity can stave off knee-jerk decisions brought on by panic.

The matrix below helps guide a potential private real estate investment allocation, based on net worth and time horizon.

PRIVATE REAL ESTATE ALLOCATION GUIDELINES

TIME HORIZON	NET WORTH			
	1–5 MILLION	5–10 MILLION	10–25 MILLION	25+ MILLION
0–5 YEARS	5%	10%	15%	20%
5–10 YEARS	10%	15%	20%	25%
10–20 YEARS	15%	20%	25%	30%

INVESTING IN FUNDS VS. DEALS

An investor should consider how much time and effort they want to put into real estate investing before they get started. If the investor has deep market knowledge, the time to find properties and the ability to execute a business plan by improving and managing properties, they can build their own portfolio of individual real estate deals. Or they can invest in a diversified real estate fund. There are pros and cons to each approach.

INDIVIDUAL REAL ESTATE DEALS

Many websites offer access to individual deals such as RealCrowd and Crowdstreet. These platforms act as the middleman between the investor and the real estate operator. Many investors choose this option because they simply prefer the control they have in picking their own deals versus trusting the process to a manager.

PRIVATE REAL ESTATE FUNDS

Funds, such as the ones we offer at Origin Investments, usually include multiple deals, each with its own business plan. This offers individual investors diversification. An investor may have the resources to buy a few buildings, but by investing the same money in a well-run private real estate fund, they get stakes in many deals that they don't have access to on their own, and have knowledgeable professionals do the due diligence on each property. These can range from apartment buildings to industrial complexes, and can be located in many cities at once to take advantage of thriving market conditions. Owning multiple properties also limits risk; if one property underperforms, it doesn't impact the others and drag down profits across the board. Individual deal investments do not offer this same benefit. If a deal fails, investors suffer substantial loss.

Finding the best private real estate fund is complicated to navigate. The best place to start would be to ask a wealth manager for recommendations, but, regardless, it's critical for investors to do their own due diligence on every deal, fund and manager they hope to use. We provide tips for the due diligence process later in this guide.

EVALUATING REAL ESTATE RISK

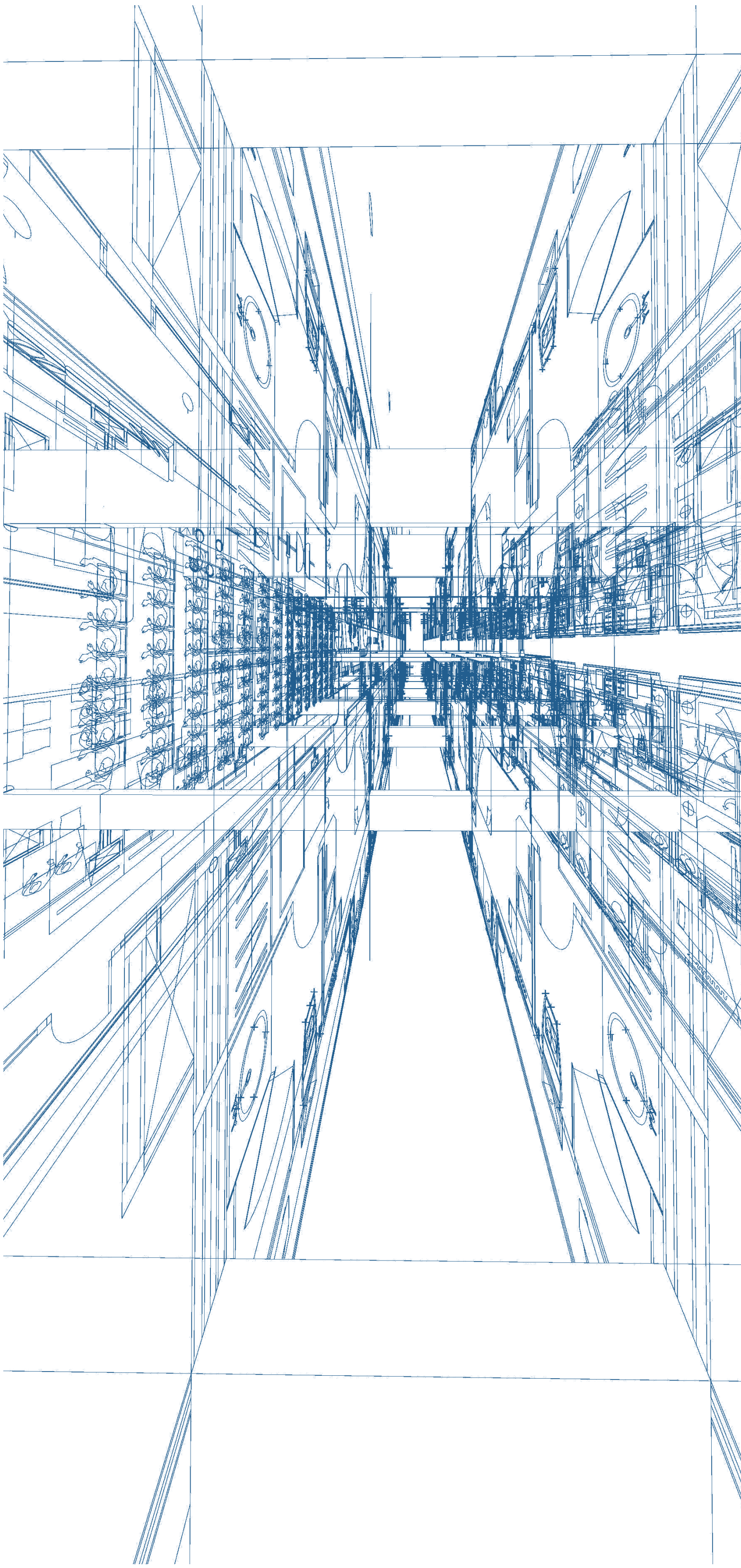
We all know real estate values rise and fall. But how likely is a move in either direction, and by how much? More significantly, is the expected performance of the investment worth the risk? The larger the risk, the larger reward one should expect. But the reverse is also true: high risk means there is a greater chance of failure.

For that reason, if one portfolio manager returns 20% on a real estate investment but takes twice as much risk as a manager who returns 15%, the smaller return is actually better on a risk-adjusted basis. That's because the fund earning 15% is taking half the risk, so the investment is more likely to offer downside protection and will have less variance around its forecasted returns. Every real estate investment should be evaluated based on its own risk-reward profile.

Here are eight risk factors investors should consider when evaluating any private real estate investment:

1. GENERAL MARKET RISK

All investments have ups and downs that are tied to the economy, such as interest rates, inflation or other market trends. Investors can't eliminate market shocks, but they can reduce the volatility of their portfolio by diversifying across a wide array of investments, including stocks, bonds, public REIT's and private real estate. A balance of public and private real estate investments helps effectively diversify across geography and sectors and effectively manage liquidity.



2. ASSET-LEVEL RISK

In real estate investing, there are different risks associated with each type of property. For instance, there's always demand for apartments in good and bad economies, so multifamily real estate is considered a low-risk investment. But for that reason, apartment buildings often yield lower returns. Office buildings are less sensitive to consumer demand than shopping malls, while hotels, with the reliance on seasonal tourism and business travel, pose far more risk than either multifamily or office investments.

3. IDIOSYNCRATIC RISK

Some risks are specific to the asset and the asset's business plan, which makes them particular to a certain situation — or idiosyncratic. Every individual deal is subject to idiosyncratic risks. Construction, for example, will add risk to a project because it limits the capacity for collecting rents during this time. And when developing a property from the ground up, investors take on more types of risk than just the construction risk.

They can also encounter entitlement risk, the chance that government agencies with jurisdiction over a project won't issue the required approvals to allow the project to proceed; environmental risks that range from soil contamination to pollution; budget overruns and more, such as political and workforce risks.

Location is another idiosyncratic risk factor. For example, buildings behind Chicago's Wrigley Field used for private rooftop parties went from boom to bust investments when a **new scoreboard** completely obliterated their views, while property values near The 606, Chicago's version of the New York's High Line, **are rising**.

A seemingly safe and passive investment is also subject to idiosyncratic risk. Tenant credit can change quickly and can make or break an investment opportunity. **Tenant bankruptcy examples** have become commonplace in the retail real estate sector, for example, as brick and mortar stores have been decimated by the competition of internet commerce.

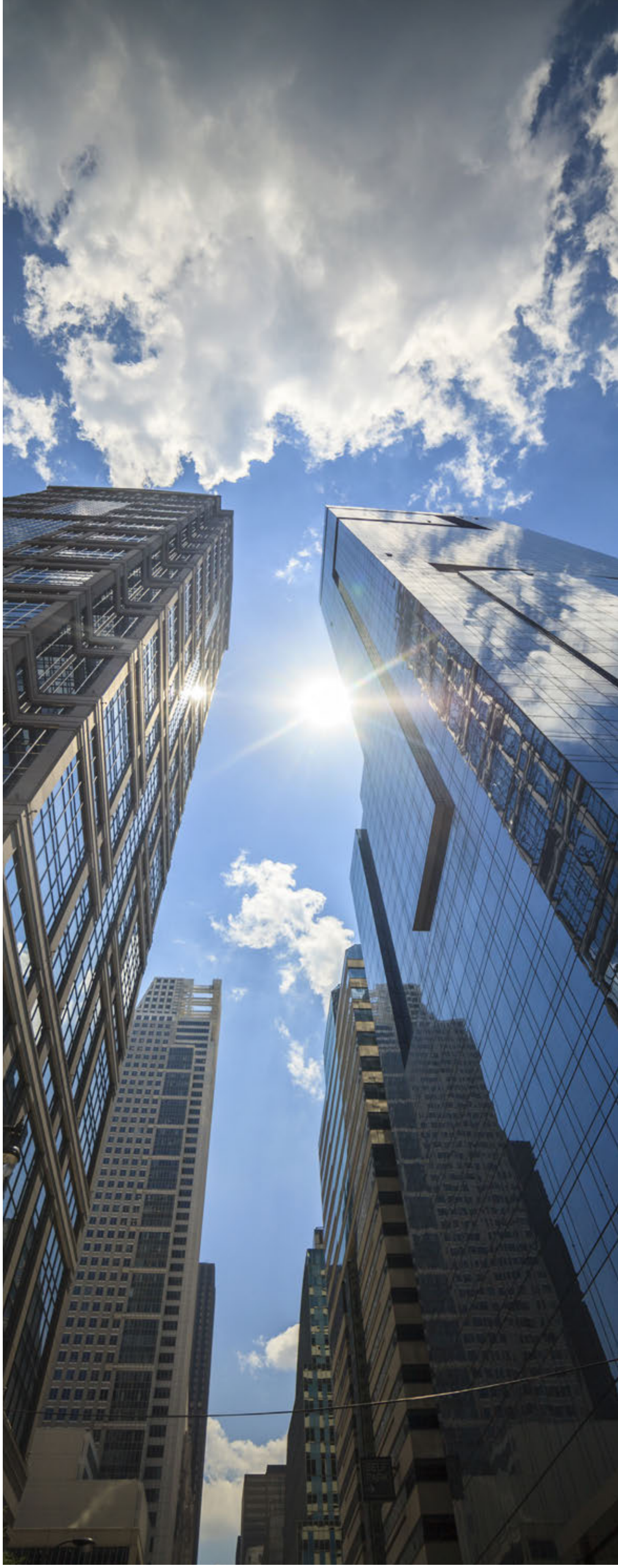
4. LIQUIDITY RISK

When an investor isn't able to sell a property quickly, liquidity risk may be at fault. An investor can expect dozens of buyers to show up at the bidding table in a place like Houston, regardless of market conditions. However, a property located in Evansville, Indiana will not have nearly the same number of market participants, making it easy to get into the investment, but difficult to get out of it. The strategy for selling a property needs to be determined when entering into a real estate investment. Smaller markets may be fine for investors planning to hold the property forever, but not for assets with a finite business plan or the investor who may need their capital back at a moment's notice.

5. CREDIT RISK

The length and stability of the property's income stream is what drives value. There is always a risk that something could happen to the property's income stream. A property leased to Apple for 30 years will command a much higher price than a multi-tenant office building with similar rents. However, even the most creditworthy tenants can go bankrupt. Remember when landlords were happy to have Sears and J.C. Penney anchor their malls?

The huge market in so-called **triple-net leases, which are often said to be as safe as U.S. treasury bonds** and require tenants to pay taxes, insurance and improvements, can fool property investors. The more stability in a property's income stream, the more investors are willing to pay because it behaves more like a bond with predictable income. However, the triple-net lease landlord is taking a risk that the tenant will stay in business for the length of the lease, and that there will be a waiting buyer.



6. REPLACEMENT COST RISK

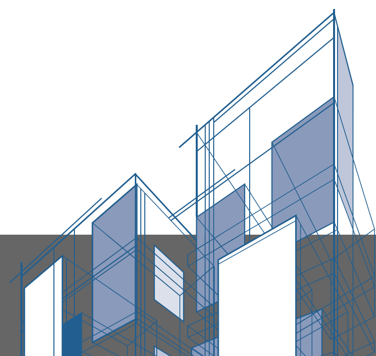
As demand for space in the market drives lease rates higher in older properties, it's only a matter of time before those lease rates justify new construction and increase supply risk. What if a new building makes the investment property obsolete because there's a better facility with comparable rents? It may not be possible for an investor to raise rents, or even attain decent occupancy rates. Evaluating this situation calls for understanding a property's replacement cost to know if it's economically feasible for a new building to come along and steal away those tenants.

To figure out replacement cost, investors should consider a property's asset class, location and sub-market in that location. This helps investors know if rent can rise high enough to make new construction viable. For instance, if a 20-year-old apartment building is able to lease apartments at a rate that would justify new construction, competition may very well come along in the form of newly built offerings. It may not be possible to raise rents or maintain occupancy in the older building.

7. LEVERAGE RISK

The more leverage (debt) on an investment, the more risky it is and the more investors should demand in return. Leverage is a force multiplier: It can move a project along quickly and increase returns if things are going well, but if a project's loans are under stress — typically when its **return on assets** isn't enough to cover interest payments — investors tend to lose a lot quickly. So in general, investments that are capitalized with more debt should project a higher return on equity investment.

In example A below, we illustrate the difference in return on equity when using 85% debt versus 70%. The project financed with 85% debt requires only $3 million of equity and generates a total return on equity of 121%, while the project financed with 70% debt requires $6 million of equity and generates a total return of 65%.



EXAMPLE A: DEBT'S IMPACT ON EQUITY IN A POSITIVE MARKET

	85% LEVERAGE	70% LEVERAGE
Cost	$20,000,000	$20,000,000
Equity	$3,000,000	$6,000,000
Debt	$17,000,000	$14,000,000
Sell amount (proceeds)	$25,000,000	$25,000,000
Accrued interest at 4% over 2 year hold (we'll ignore amortization for the sake of simplicity)	$1,360,000	$1,120,000
Gain/loss on equity investment	$3,640,000	$3,880,000
Total return on equity	**121%**	**65%**

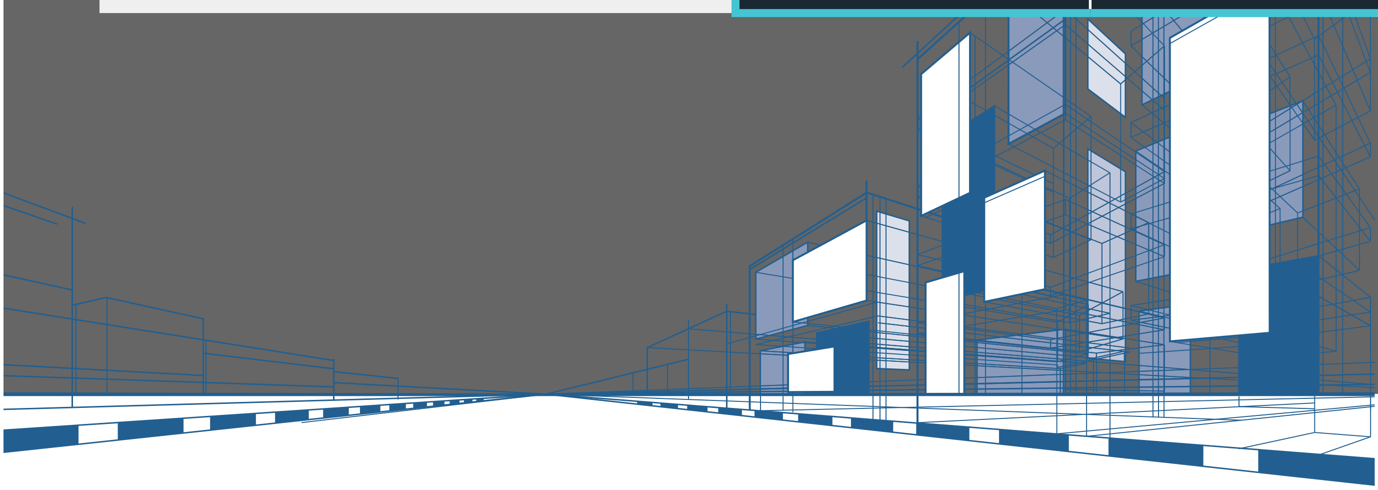
However, looking at example B, you can see how debt works both ways and how quickly the returns can change in a down market. If the market were to decline by just 5%, investors using 85% leverage would lose 79% of their invested capital, while investors who levered at 70% would lose only 35%.

As a rule, **leverage should not exceed 75%**, including mezzanine and preferred equity. Returns should be generated primarily from the performance of the real estate — not through excessive use of leverage. Highly levered projects shouldn't necessarily be avoided altogether; investors just need to make sure they receive a return commensurate with the risk.

Unfortunately, there is no set rule or scale that dictates the exact incremental return one should expect to receive for one higher leveraged investment over another. The great equalizer when comparing investment opportunities to one another is to look at them on an unlevered basis. Generally, the one with the higher unlevered return is going to provide the better risk-adjusted return once debt is applied, assuming all of the inputs are realistic.

EXAMPLE B: DEBT'S IMPACT ON EQUITY WITH A 5% MARKET DECLINE

	85% LEVERAGE	70% LEVERAGE
Cost	$20,000,000	$20,000,000
Equity	$3,000,000	$6,000,000
Debt	$17,000,000	$14,000,000
Sell amount (proceeds)	$19,000,000	$19,000,000
Accrued interest at 4% over 2 year hold (we'll ignore amortization for the sake of simplicity)	$1,360,000	$1,120,000
Gain/loss on equity investment	($2,360,000)	($2,120,000)
Total return on equity	**-79%**	**-35%**



8. STRUCTURAL RISK

This has nothing to do with the structure of a building; it relates to the **investment's financial structure** and the rights it provides individual participants. A joint venture is when multiple operators come together to own one investment property, and this is where structural risk comes into play.

In joint ventures, investors must be aware of their legal and profit sharing rights, which are spelled out in the operating agreement of the partnership. The operating agreement will detail how much of the compensation they will have to pay the manager of the LLC throughout ownership and when a property is sold.

If an investor is a limited partner, the gross profits will be diluted by the compensation that's paid to the LLC managers. The terms in the operating agreement will help the investor understand how much of the profits they will receive if the deal is successful.

The operating agreement also details the specific requirements to remove a manager, should the situation arise. Partnerships always start with good intentions and a good partner is invaluable. On the flipside, nothing is worse than having a **bad partner** who doesn't know what they are doing, who behaves unethically, or is undercapitalized. The terms should outline the standards for manager removal and what percentage of limited partners it takes to remove them. It's important to look for a manager who is also heavily invested in the deal, is well-capitalized so they are on equal footing with the limited partners and are well-compensated when the deal succeeds.

UNDERSTANDING INVESTMENT RETURNS

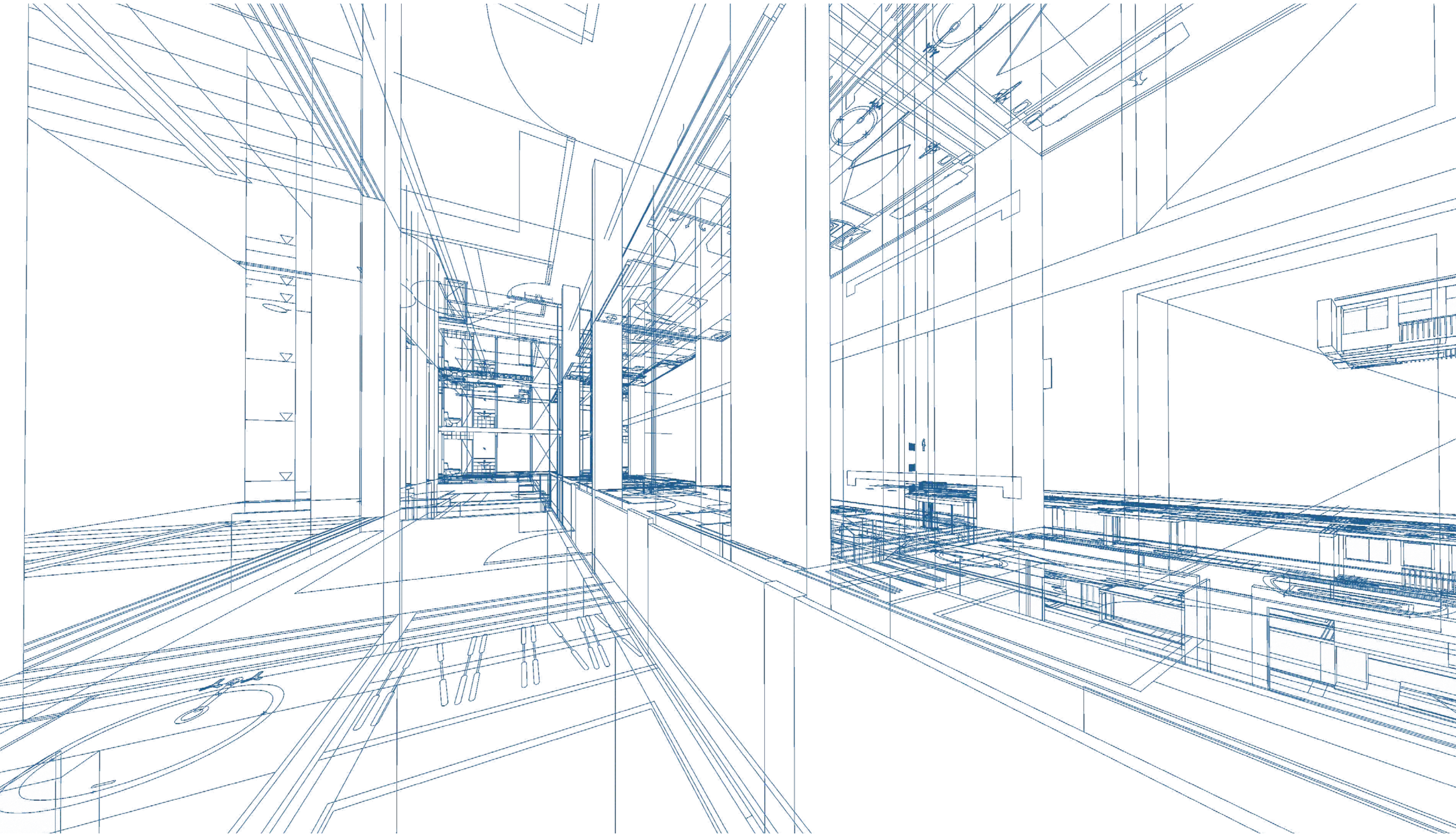
There are two metrics real estate managers use most often to describe their return on investment: the equity multiple and the internal rate of return (IRR). The educated real estate investor needs to use both equity multiple and IRR to evaluate and compare investment returns.

The equity multiple reflects the amount of money an investor earns by the end of a deal and is expressed in terms relative to the original investment dollars. For example, if an investor puts $1 million into a property and eventually gets back $2 million, the multiple is 2x. Knowing the multiple on equity shows an investment's true impact on wealth.

IRR describes the time-weighted compounded annual percentage rate every dollar earns during the time it is invested. It accounts for the value of money over a certain period of time. The easiest way to calculate IRR is to plug an investment's cash flows into Microsoft Excel and use the "=IRR" function.

IRR has inherent limitations that are explored in more depth later in this guide, but the biggest challenge with IRR is that it doesn't quantify the amount of wealth the investment created. Generating a 17% IRR over five years sounds great, but not if it generates only a 1.3x multiple on invested equity.

You can't spend IRR.



COMPARING INVESTMENT RETURNS

An annualized total return is the average amount of money earned by a real estate investment each year. Many investors mistakenly compare IRR to the annualized return to make investment decisions, which can be a costly mistake. Private equity real estate investors can find many impressive IRRs available on short-term deals. But investors must pay close attention to the time period it took to achieve the IRR and the real wealth that was created by using IRR in context with the multiple on invested equity.

For example, a 30% IRR over three months works out to a total return of only 7.5%. However, real estate is not a liquid investment. Its true potential and return on investment is not in short-term profits, but in holding for the long term. It's better to have the investor's capital generate a 12% annualized return over three years than an 18% IRR over three months.

Chasing high IRR with investments that have short durations is one of the biggest mistakes investors make. Before an investor commits to a private real estate investment, they should evaluate the manager's past IRR track record against the equity multiple track record to determine how much actual wealth the manager created for investors.

In example C below, we look at two $100,000 investment scenarios. In both, investors had their money tied up for three years, but the investor in the second scenario made far more than the other, despite both scenarios generating a 15% IRR. The first scenario produced a 28.5% total gain on equity, as compared to a 52% total gain on equity in the second scenario. In scenario one, the investor would have needed to immediately **invest any cash flow they received into other investments**. However, it's impossible to predict what investments will be available in the future and it takes time, energy and discipline to find a suitable place to reinvest distributions.

To be fair to the concept of IRR, getting money back sooner rather than later helps reduce risk. Cash flows that happen far out in the future are generally riskier than cash flows that are expected to occur earlier. And, cash flow would presumably be invested into other investments at the time it is received.

EXAMPLE C: TWO $100K INVESTMENTS, BOTH GENERATING A 15% IRR

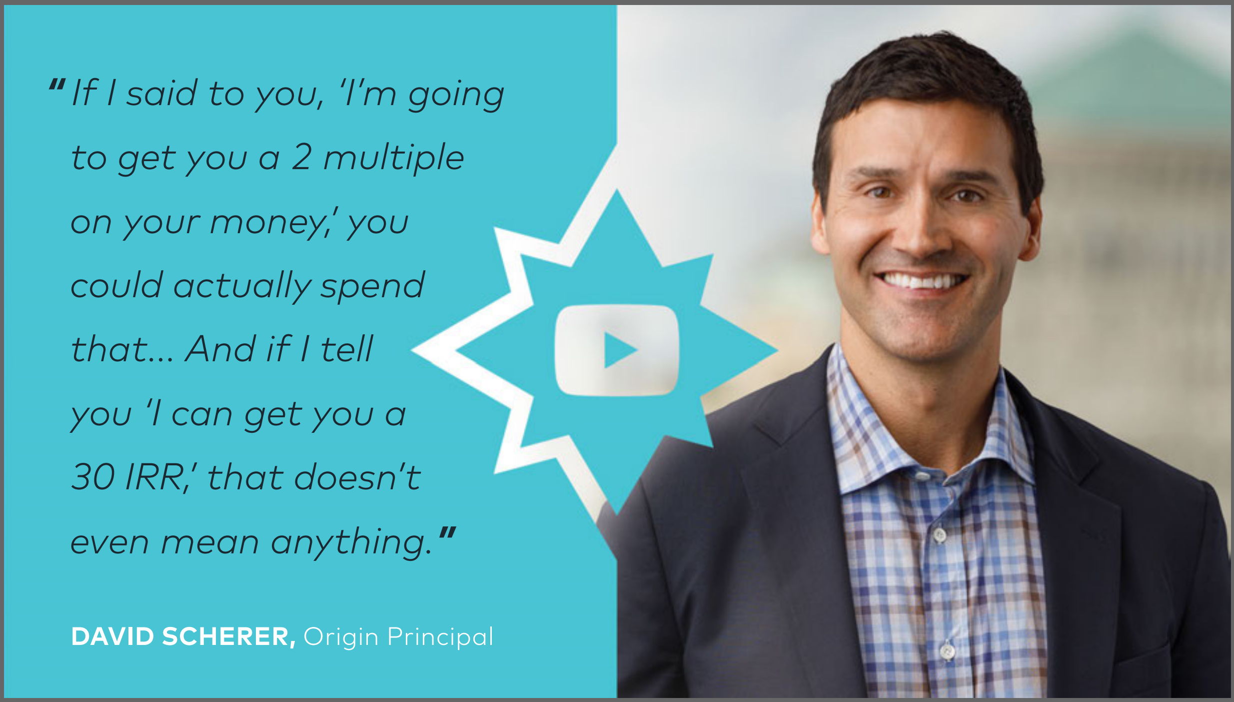
SCENARIO #1

Initial investment	($100,000)
Year one cash flow	+ $50,000
Year two cash flow	+ $50,000
Year three cash flow	+ $28,500
Total gain on equity	**$28,500**

SCENARIO #2

Initial investment	($100,000)
Year one cash flow	+ $0
Year two cash flow	+ $0
Year three cash flow	+ $152,000
Total gain on equity	**$52,000**

WATCH: ORIGIN CO-FOUNDER DISCUSSES IRR VS. EQUITY MULTIPLE



HOW IRR CAN BE MANIPULATED

IRR is calculated using dollars that flow to and from investors. The shorter duration between contributions and distributions, the higher the IRR. IRR is susceptible to manipulation by managers because they have the ability to influence the timing of cash flows. This makes it difficult to tell the difference between managers who create value and managers who financially engineer returns.

The most common abuse in manufacturing IRR amongst fund managers involves the use of a subscription line, which is a credit facility provided by a bank that is collateralized against investor commitments. Fund managers use subscription lines to close on deals quickly and manage cash flow. The bank knows the fund manager can always call capital from investors to pay down the line, which is why they are willing to extend them affordable credit. Subscription lines generally mature at the same time the fund's investment period ends, which can be three to five years after the fund's final close.

A manager can manipulate IRR by funding deals directly through the subscription line and then holding the deal there for as long as possible instead of calling capital from investors. A manager can delay calling capital for years with a flexible subscription line. This greatly enhances the investment's official IRR at the expense of the investor, who sits on their capital commitment and pays fees while the manager loads up the subscription line with deals. Even worse, managers typically receive higher incentive fees for higher IRRs, so a manager could use the investor's balance sheet to obtain cheap capital in order to make more fees.

In example D, we show how a manager can easily manipulate IRR. In both scenarios, the investor commits $100,000 and all deals are acquired in the first year. In the first scenario, instead of using the subscription line, all of the capital is called from investors, resulting in an IRR of 14%. In the second scenario, the manager uses a subscription line to fund the deals instead of calling capital from investors until the second year, resulting in an IRR of 30%.

Private real estate managers need to be evaluated not only on their ability to produce IRR, but also on their ability to invest capital in a reasonable time period. Reviewing a manager's historical track record is the best indicator of how a manager produces IRR. Though past returns may not be indicative of future returns, a manager who has a history of manipulating IRR will undoubtedly use the same trick again in the future.

EXAMPLE D: TWO $100,000 INVESTMENTS RESULTING IN DIFFERENT IRRS

SCENARIO #1

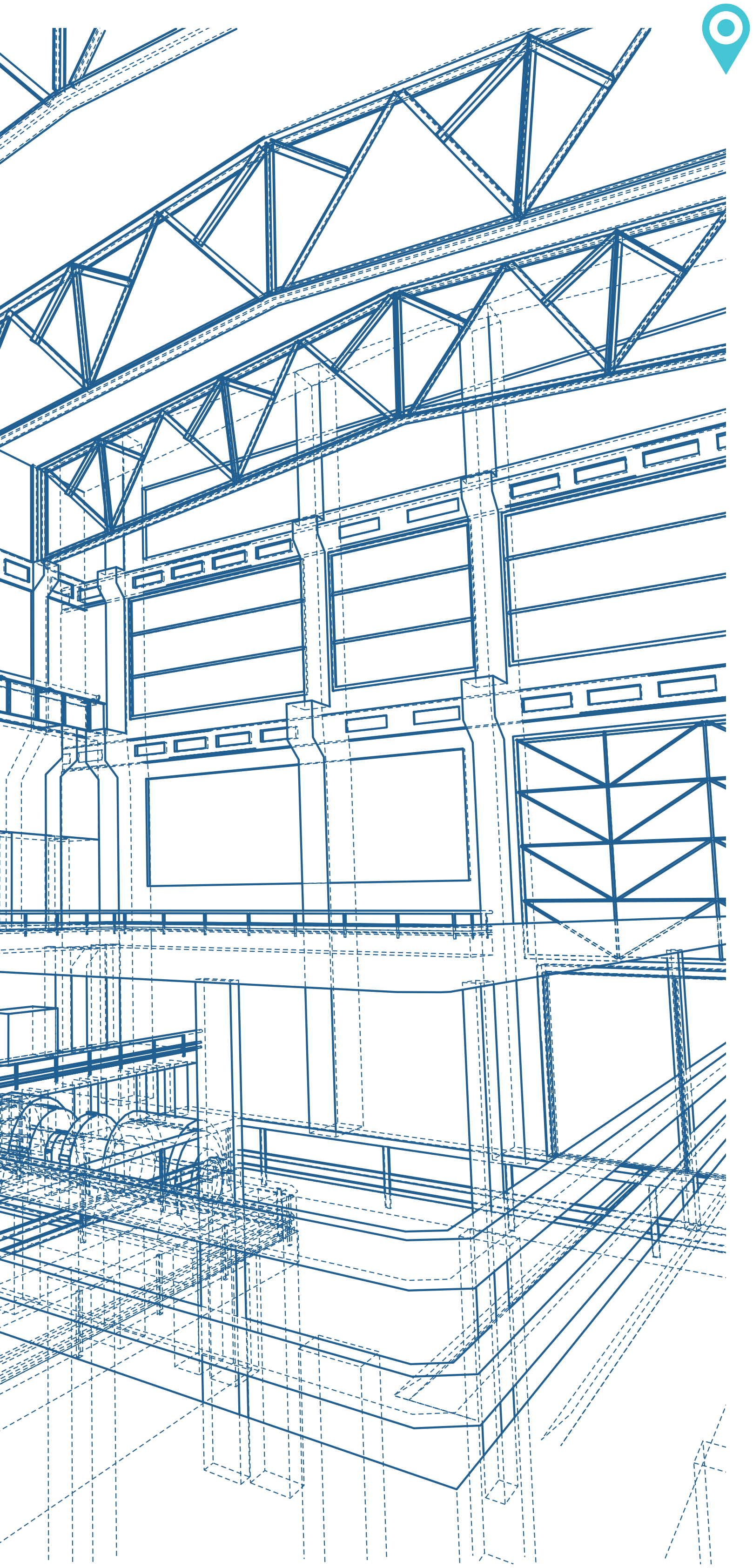
Year one	($100,000)
Year two	$0
Year three	$130,000
IRR	**14%**

SCENARIO #2

Year one*	$0
Year two	($100,000)
Year three	$130,000
IRR	**30%**

*Subscription line used to fund deals

WHAT TO LOOK FOR IN A MANAGER



Projecting real estate returns is an inexact science. There are hundreds of assumptions that go into building a financial model, and every input is at the discretion of the investment manager. Every private real estate investment starts with a promise of high returns. Some will exceed projections while others will fall short, and many will actually lose money. So the challenge for private real estate investors is trying to figure out which opportunities will meet or exceed expectations, and which ones will become a "learning" experience.

In real estate investing, it's more about who one invests with than what they invest in. It's the manager who decides what price to pay for an asset, how to build value, the appropriate capital structure, how to course correct when things go wrong and **when to exit**. A good manager will be realistic and thoughtful about the assumptions. Finding a real estate manager who will behave reasonably and responsibly is paramount to success in this industry.

Asking the right questions of a manager during the due diligence phase is critical. Only then is it possible to understand if their investment strategy aligns with an investor's personal risk profile. Think of it as a job interview, and the investor is hiring the manager to be a good steward of their capital and a good partner. Unfortunately, too many deals get funded with nothing more than great marketing materials. And there are many unqualified investment professionals in today's market passing themselves off as experts.

Here are ten questions that investors should ask to get a telling picture of a real estate manager's approach, ethics and potential performance — and what to look for in their answers to identify the best managers. But keep this caveat in mind: just because a manager may not meet every criteria on this list, it doesn't mean they should be written off. It's key to listen for cues in their answers that shed light on their honesty and integrity.

1. HOW HAVE YOUR PAST DEALS PERFORMED?

Track records are hard to fake. Evaluating a manager's past successes or failures is a great measuring stick for how well the current opportunity will turn out. It's important to gauge if they have delivered consistent returns across all of their deals. A manager who has produced a 15% IRR over the last ten years without losing any money is far different than a manager who produced 15% IRRs, but gained money half the time and lost money the other half. Additionally, if the manager suggests that their new fund will generate 30% returns, but they've never generated 30% returns before, there is a low likelihood that they will actually meet their projections.

Good managers don't lure investors with the expectations of high returns. They set realistic expectations and strive to meet those expectations in bad times and outperform them in good times. Real estate investing is not a get rich quick scheme where investors should be taking high risk.

2. HOW MUCH OF YOUR OWN MONEY ARE YOU INVESTING?

Alignment is everything. The manager should be investing a significant amount of his or her own capital (capital not funded by others) right along with the investors. And the bulk of his or her earnings should come from investment returns —

not transactional fees. "Skin in the game" ensures the manager is motivated by the right outcome. Managers should win when their investors win, and lose when their investors lose.

3. HOW IS YOUR TEAM INCENTIVIZED?

It takes a team to see an asset through — from acquisition to sale. Making sure the team is aligned through performance is critical. Investors should ask the manager if their team is incentivized based on transactions or performance. Additionally, ask how they retain key team members and what their retention rate is.

Conflicts of interest are prevalent in this industry and minimizing them is important. One way to do so is by making sure that the team is compensated based on performance and not on transactions. Also, investors should make sure that the team that is in place today is the same one that was responsible for delivering the manager's historical returns.

4. WHAT IS YOUR COMPETITIVE ADVANTAGE IN THE MARKET?

It's important to know what the manager believes his or her team does better than anyone else in the marketplace. This competitive advantage is generally something quantifiable. For example, if they say their competitive advantage is in **sourcing opportunities**, then ask how many deals they look at before they pick the best ones, and ask where they find their deals. If their competitive advantage is in operations, then they should be able to benchmark themselves against an industry standard.

5. HOW DO YOU COMMUNICATE TO YOUR INVESTORS?

Communication is paramount to a successful relationship. Timely and accurate reporting is one of the most important elements of a good manager because there is nothing worse than being in the dark. Investors should ask for sample reports from their latest deals and play close attention to the dates to make sure they are delivered quarterly. Take note of what the reports cover and if the manager **updates investors** about both good and bad news. The end investment performance is what matters most, but a manager who communicates poorly can cause some sleepless nights and a lot of frustration.

6. ARE THE ASSUMPTIONS IN YOUR FINANCIAL MODEL REALISTIC?

Projections are only as good as the inputs and every one of the inputs is at the discretion of the manager. No real estate manager is 100% accurate in their business plan assumptions. What is important is that the manager conducts a stress test of each input into their financial model, which means quantifying what under-performance on each input will do to the expected investment outcome. The basis of protecting downside and limiting losses is in understanding how an investment will perform if and when things don't go the expected way.

One of the best ways to learn about a manager's approach is by inquiring about the assumptions they use in their model and asking what the deal looks like when their assumptions are taken to the extreme. Sometimes small tweaks to one or two variables, such as **the growth rate or cap rate**, can vastly impact returns.

The next input to note is net operating income. Good managers create value by increasing net operating income, which is impacted most by occupancy and rental rates. Look at their assumed growth rate of revenue and their occupancy assumptions. Every deal has an occupancy assumption at stabilization. Make sure the property is in line with the rest of the market, or slightly below it.

Investors should also understand how the manager treats expenses. Expenses will increase, so it's important to ensure the manager applies a realistic inflation rate to all costs associated with executing the business plan. Property tax increases, for example, can have a big impact on the bottom line, so make sure the manager is resetting them based on the new purchase price and not using historical figures. Also, ensure the manager takes into account a rising interest rate market and a rising cap rate environment in the underwriting. Every model should account for higher interest rates.

Be sure that you know how much leverage the manager uses with each deal. As we discussed earlier in the guide, used responsibly, leverage can enhance returns. But beware of deals that are financially engineered with mezzanine debt and preferred equity. Ask if the manager cross collateralizes assets. Cross-collateralization of assets is when one asset is used to guarantee the debt on another asset. In a fund structure, assets should not be cross-collateralized because it destroys diversification and magnifies risk.

This practice played a large part in why private real estate investors lost so much money during the financial crisis and is very prevalent in real estate debt funds, so investors must read the fine print. Also, understand if they personally guarantee loans, because doing so can be catastrophic for a manager and the investors if that loan gets called.

Most importantly, be familiar with their business plan and if it seems realistic, as most plans fail because they are ill-conceived from day one. Use a common-sense approach; for example, a Class A property can't also be home to low-income renters. A business plan should be easy to understand and make sense intuitively.

7. WHAT WAS YOUR WORST DEAL AND WHAT DID YOU LEARN FROM IT?

Every manager has multiple bad deals in their past. Investors should actually want a manager who has been in the trenches and has some battle scars to prove it. A good manager will be forthright about their mistakes, what they leaned, and how those deals helped shape the firm's investment philosophy. It's the job of the investor to decide if these are one-off isolated events and if the manager is being sincere versus if there is a history of pursuing risky deals with ill-conceived business plans. It's important to understand if the manager communicated to investors during any down periods. How they treated the investor during a down period is an indicator of their integrity.

8. CAN I SPEAK WITH ONE OF YOUR CURRENT INVESTORS?

Investors should also ask to speak with one of their current investors or a former investor. Ask about their experience and if they recommend the manager. A really creative investor could also get in touch with one of their former employees through LinkedIn and ask them about the company.

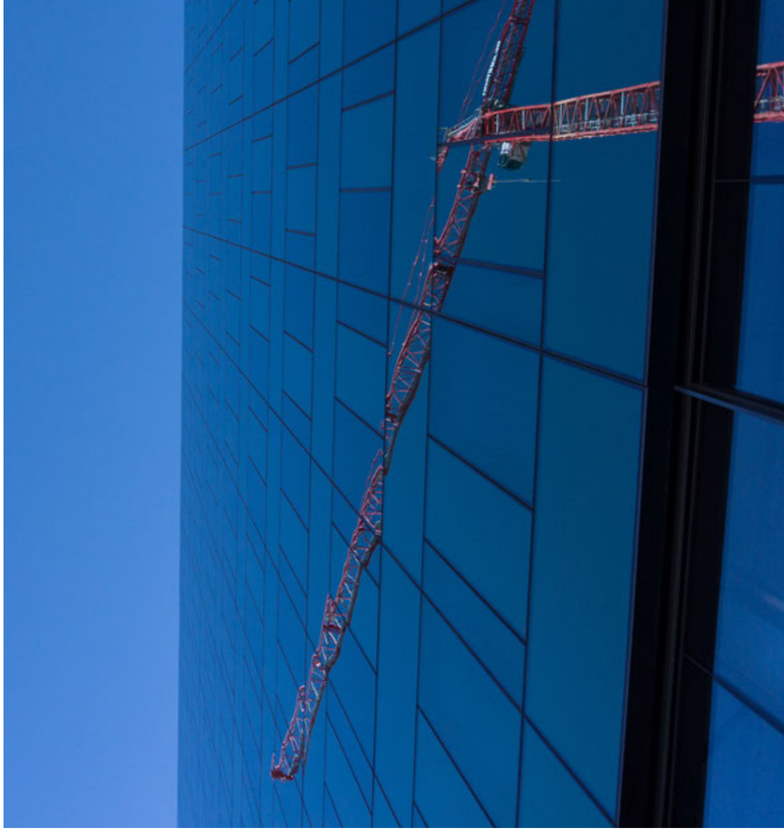
9. HOW IS YOUR COMPANY FUNDED?

It's important to determine whether or not the company has ample cash flow to pay the bills or if they'll need to lean on their investors for additional capital. Assess if there any risk that they will go out of business by looking at their balance sheet. Avoid managers who operate on shoestring budgets or are just starting out. When considering investing in a fund, it may be better to wait until Fund II or III, after the kinks have been worked out. Regardless, experience matters and it's important to invest with an experienced and well-financed team.

10. WHAT IS INCLUDED IN YOUR FEES?

Another important part of vetting a manager is understanding the fees they charge. Real estate investing requires a dedicated team of people to be successful and transaction fees help pay for that team. Someone must find the property, negotiate the price, create marketing materials and legal documents, raise equity, manage the day-to-day operations at the property, formulate and execute the business plan, report to investors, **provide K-1's**, sell the asset and distribute the proceeds. A great team does not come cheap, and fees help managers attract and retain high-quality employees.

Unlike the public markets, real estate is not a business where you want to base a decision on fees alone. There is a big difference between price



and value and **low fee real estate deals can end up being very expensive**. The quality of a business plan and the asset manager who runs it make the most impact on the success of a project. Fees are a function of the complexity of a business plan and should be correlated to the value the manager is able to create. There isn't necessarily a set market rate fee, but there is a range that is fair.

Investors should be sure to ask about every fee throughout the structure because sometimes fees are buried in other LLCs below the investment entity. Fees should be outlined in the Sources and Uses of Capital section of the marketing materials or the **Private Placement Memorandum** and this is a must-read when evaluating any investment opportunity. Ask the manager what their fees are and how they are structured.

In the end, fees should guide — not drive — an investor's decision about whom to invest with. What matters most is the return on investment after all fees are considered and if that is an appropriate return for the level of risk. We'll cover more about fees in the following section.

PRIVATE REAL ESTATE INVESTMENT FEES

When vetting investment opportunities, look for a fee structure that is largely performance-based, so the manager wins when the investor wins. There is a difference between fees that are used to create investment value and exorbitant fees that simply make the managers of private equity real estate funds wealthy at the expense of their partners.

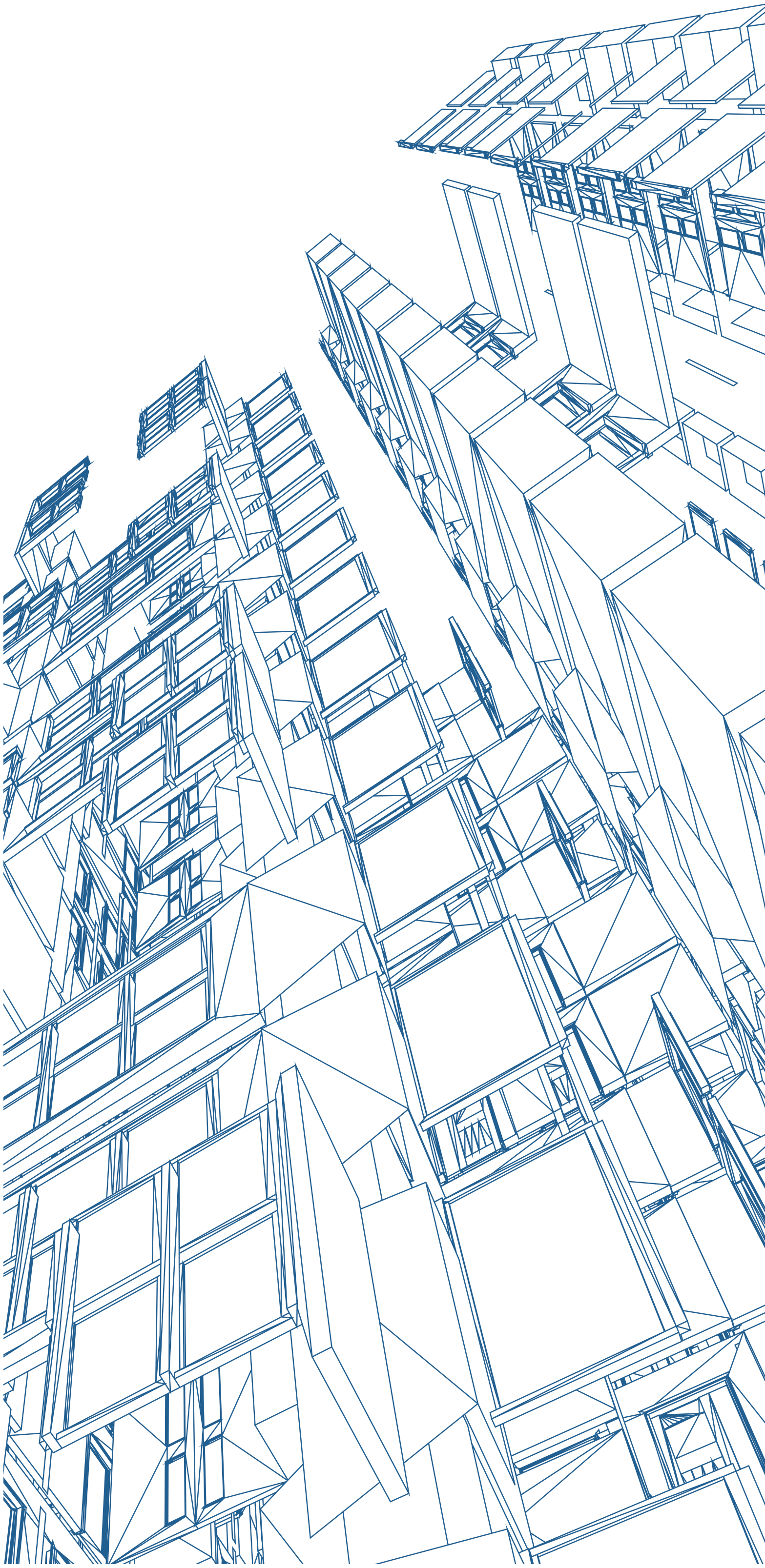
There are two main types of fees in real estate investment management: transaction fees and performance-based fees.

REAL ESTATE TRANSACTION FEES

Transaction fees are guaranteed. The manager gets paid these fees regardless of how the deal performs. Below are the most common transactional fees.

Acquisition Fee: This fee is most common amongst managers syndicating individual deals. The acquisition fee is usually between 1% and 2% of the total deal size and is generally on a sliding scale. The bigger the deal, the lower the fee. This is a market rate fee and is justified because the manager probably looked at 50 deals to find this one. The manager already paid all of the dead deal and personnel costs out of their own pocket.

Also, words matter in legal documents. Acquisition fees are paid on the total deal size, as opposed to equity invested. This is a significant difference because a 1% acquisition fee on a $30 million property comes out to $300,000. Most properties are typically leveraged using two-thirds debt, so the required equity may only be $10 million, meaning that $300,000 fee equates to a 3% cost of equity invested.



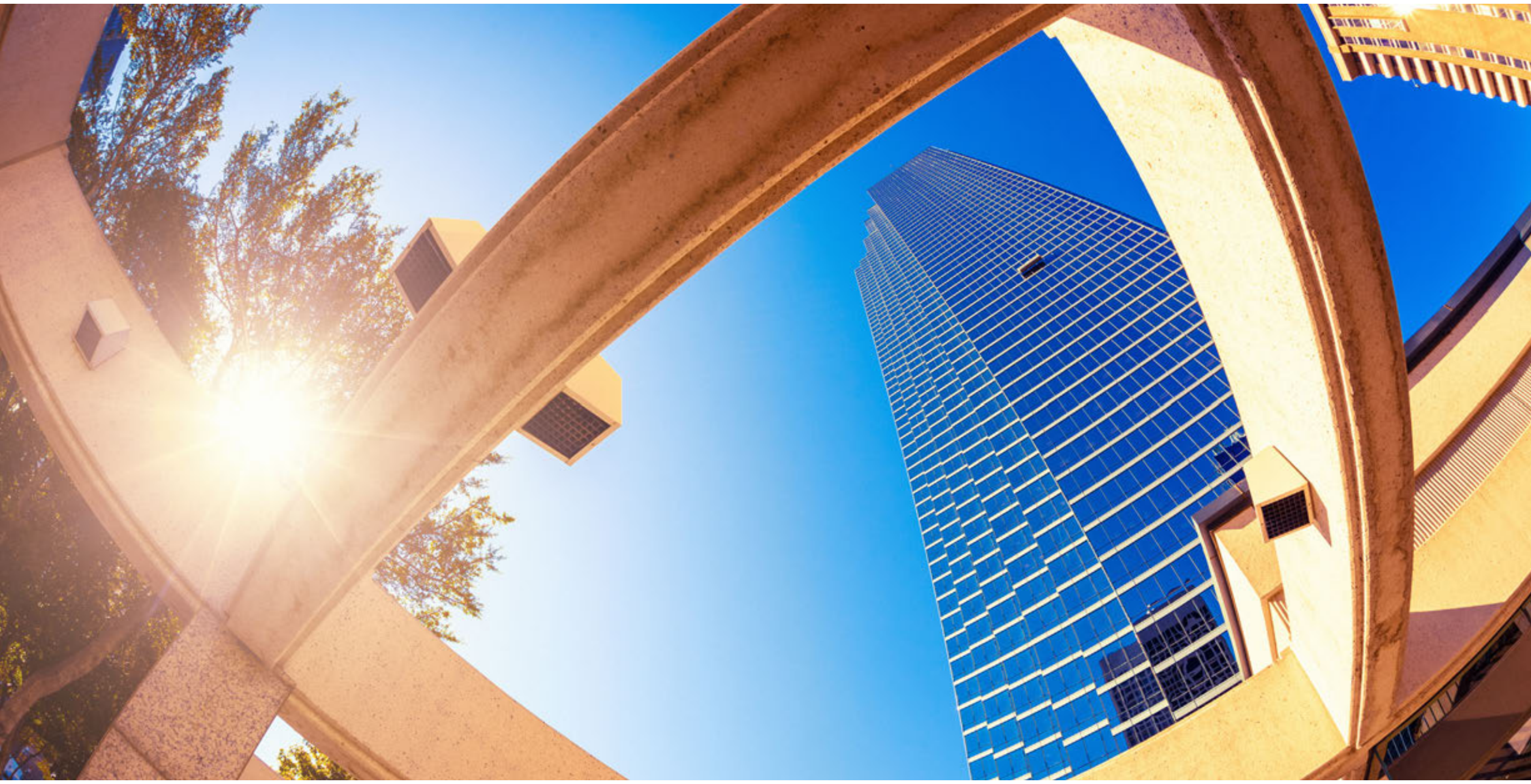
Committed Capital Fee: This fee is typically charged by called capital real estate funds and ranges from 1% and 2% on committed equity. The manager receives this fee even if the capital is not invested. If a committed capital fee is charged, an acquisition fee should not also be collected, as this is what the industry calls "double-dipping." Unfortunately, many managers try to get away with double-dipping when serving individual investors.

Investment Management Fee: This fee is charged by both funds and managers sponsoring individual deals and is sometimes referred to as the Asset Management Fee. For real estate funds, this fee replaces the committed capital fee once the capital is invested so that investors are not being charged on the same capital twice. The commitment fee is reduced proportionally as money becomes invested. This fee ranges between 1% and 2% of invested equity and is used to pay for investment management services. Again, terminology matters, so this fee should be a function of invested equity and not total deal size.

Set up and Organizational Fee: Both real estate funds and managers of individual deals incur set up costs. These are typically passed through to the investment entity and paid by all investors. One-time upfront costs include legal, marketing, technology, investor relations, and other costs associated with capital raising and forming the investment company. This fee is typically between .5% and 2% of total equity.

For individual deals, these are generally not a line item easily identified in the marketing materials and are often costs that are lumped into the property's acquisition cost. Investors should be aware of this line item and ask the manager to explain the terms in specific detail to know exactly what this fee is being used for.

Administrative Fee: These fees cover tax reporting, audits, fund administration and third-party software. They typically range between .10% and .20% per year on invested equity.



OTHER TRANSACTION FEES TO LOOK OUT FOR INCLUDE:

Debt Placement Fee: This is a fee that is often paid to an outside broker, which is standard industry practice for lining up debt. The typical fee between .25% and .75% of total debt, depending on deal size. A good broker can save a project a lot more than the cost of this fee. However, some managers try to layer on their own internal fee on top of a debt placement fee to the tune of between .25% and .75%. This is very impactful to equity, as the amount of debt used in a typical transaction is two times larger than the amount of equity.

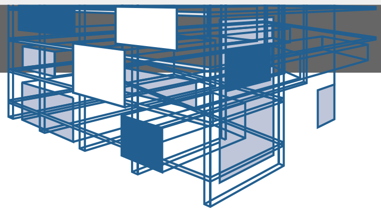
Refinancing Fee: This is similar to a debt placement fee and some managers charge between .25% and 1% for this service.

Wholesale Marketing Fee: This fee is typically paid to the broker dealer by non-traded REITs for product distribution and equates to roughly 3% on equity.

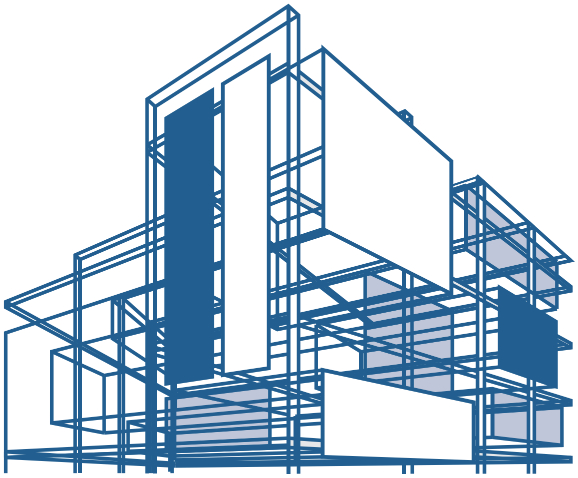
Advisor/Syndication Fee: Some real estate companies such as private REIT's use broker-dealers to distribute their products through an advisory network. These advisors are typically paid an upfront, one-time fee of between 4% and 7%. Some sponsors will charge a smaller upfront fee but add acquisition or transaction charges. Often these commissions are hidden in the fine print that itemizes capital spending.

Joint Venture Fees: By themselves, joint ventures don't add another layer of fees, but the investor is then paying two managers instead of one. If the investment manager is simply providing access, then those fees should be much lower than a manager who adds value to the joint venture by executing the business plan.

Selling Fees: It's always good practice to take a project to market to generate the highest value. Typically, brokers are paid between 1% and 3% of sales price, depending on project size. Some managers charge their own internal fee between .25% and .75% on top of that.



While this may seem like a lot of fees, a good manager will limit what fees they charge and how much. Transaction fees are meant to keep the lights on but not be a profit center for the company. While we don't believe fees should guide a decision, they can tell you something about the manager. A manager trying to extract every last penny out of the deal through guaranteed transaction fees is a clear sign that they don't have the investor's interests in mind.



REAL ESTATE PERFORMANCE FEES

Performance fees are variable, based on the success of the real estate investment. They are common in nearly every private equity investment — even beyond real estate — and are used to align the interests of the manager with those of the investor. The typical performance/incentive fee entitles the manager to between 20% and 30% of profits.

An investment waterfall is a method used in a real estate investment to split the cash profits among the manager and the investor to follow an uneven distribution. In most waterfalls, the manager receives a disproportionate amount of the total profits relative to their investment. For example, a manager may only put in 5% of the investment capital but be entitled to 20% of the profits.

Performance fees are usually subject to what is called a preferred return hurdle, which is the rate of return tier (usually as defined by a certain IRR or equity multiple) that must be met before the manager begins to participate in the profits. These tiers are what define the various profit splits. The preferred return typically ranges from between 7% and 10% annually and can be viewed as an interest rate on investor capital, but it's not guaranteed.

There are two common types of waterfall structures used in both real estate funds and individual deals – European and American. In a European waterfall, 100% of all investment cash flow is paid to investors in proportion to the amount of capital invested until the investors receive their preferred return, plus 100% of invested capital. Once these distributions have been paid out, then the manager's portion of the profits increase. This is the most common waterfall used in real estate fund structures.

In the American waterfall, the manager is entitled to receive a performance fee prior to investors receiving 100% of their capital back, but usually after receiving their preferred return. To protect investors, there is usually a caveat in the documents that states the manager is only entitled to take this fee so long as the manager reasonably expects the fund or deal to generate a return in excess of the preferred return. It's not uncommon for income products that have longer hold periods to be structured with this type of waterfall or deals with hold periods that are longer than 10 years.

Waterfall structures can impact investment behavior and investors should make sure the manager is motivated by the investment return. Investors should make sure that if the investment doesn't perform as planned, the manager doesn't take a performance fee. Getting into a structure where everyone's interest are aligned from day one is the key to successful investing.

EDUCATIONAL RESOURCES FOR THE PASSIVE REAL ESTATE INVESTOR

Origin Investments provides articles, newsletters and guides to help individual investors make smarter private real estate investing decisions. View more educational resources at originvestments.com/blog.

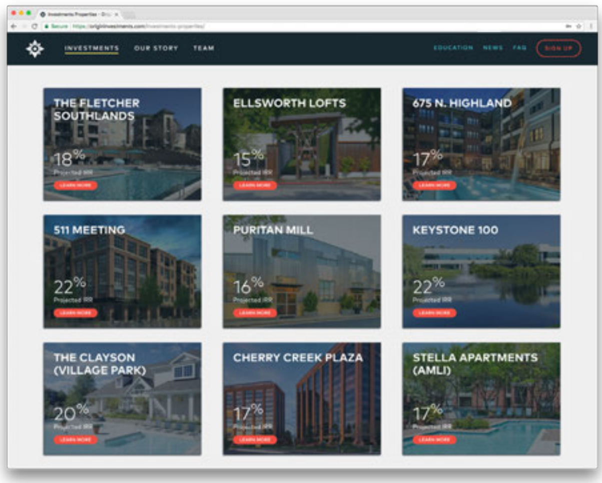
Other Resources:

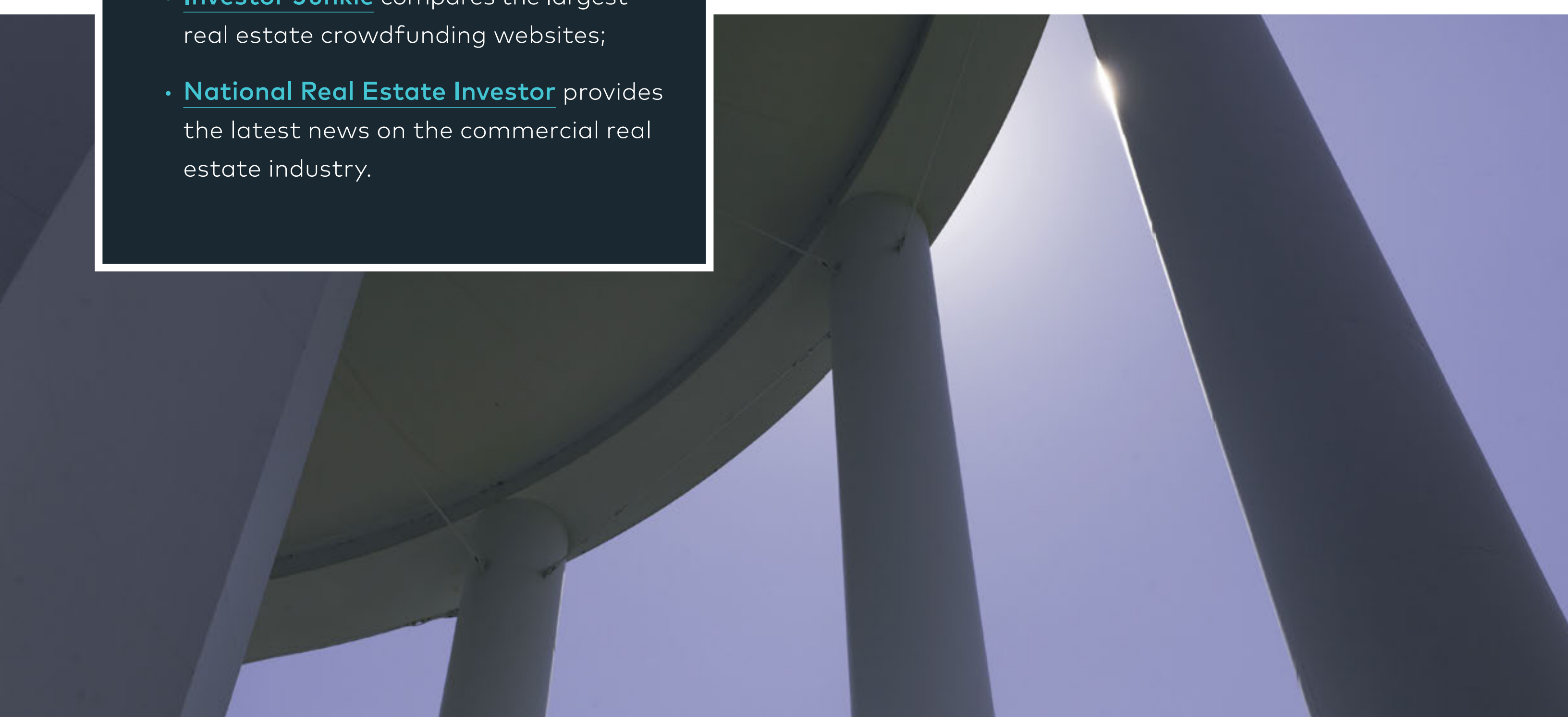
- A Student of the Real Estate Game offers information on how to invest passively in real estate, from an acquisitions manager at a private investment firm;
- White Coat Investor provides information on real estate investing for doctors, from the perspective of a doctor;
- 506 Investor Group is a group of accredited investors who share information on real estate investments;
- Investor Junkie compares the largest real estate crowdfunding websites;
- National Real Estate Investor provides the latest news on the commercial real estate industry.

ABOUT ORIGIN INVESTMENTS

Origin Investments is transforming the way individuals invest in commercial real estate. We invest side-by-side with investors, adhere to a disciplined investment philosophy, and use technology to make it easy to manage investments. Origin's first two funds have achieved top quartile performance, per Preqin data. We recently raised over $150 million for Origin Fund III.

Sign up at origininvestments.com to explore our investment opportunities.





ABOUT THE AUTHOR

Michael Episcope, Principal and Co-founder

Michael is Origin's principal, co-chairs the Investment Committee and oversees investor relations, marketing and company operations. He brings 25 years of investment and risk management experience to the company, and believes that calculated risk-taking in inefficient markets is the key to building wealth.

He frequently shares his knowledge with individual investors on Origin's blog, Forbes, ValueWalk and Huffington Post, and his expertise has made him a frequent speaker on real estate investment panels and podcasts.

Michael learned about the physical aspects of real estate in his youth as he helped his grandfather manage his apartment buildings on Chicago's West Side. He began college at DePaul University and a year later was introduced to the floors of the Chicago Mercantile Exchange. He continued to work full-time on the trading floor for the next 16 years while attending night courses to complete his undergraduate degree. After rising from runner to broker, Michael was given an opportunity to become a floor trader by a Chicago based hedge fund, Tradelink, LLC, and then enjoyed a prolific nine-year trading career. Trader Monthly Magazine named him one of the top 100 traders in the world twice.

In 2005, with two children and a third on the way, Michael cashed in his chips and retired from trading. His new focus was in managing the wealth he had accumulated. He enrolled in a master's program in real estate at DePaul and co-founded Origin Investments two years later with **David Scherer**.

Michael is the former president of the DePaul Real Estate Alumni Alliance and a sustaining sponsor of the DePaul Real Estate Center. He has been a Vistage member for more than six years and lives in Chicago with his wife and three children. He enjoys traveling with this family and snowboarding, and frequents ski resorts all over North America.