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INVESTMENT BANKING CASE STUDY: PRIVATE MULTIFAMILY VALUE-ADD OPERATOR

Note: In the interest of adhering to private securities regulations, we do not disclose the names of our clients.

How this real estate operator went from the brink of prison to a rock solid investment opportunity for retail investors within 6 months… raising over $60MM per year!

Our first investment banking client was a firm based in Dallas pursuing value-add opportunities in Chicago. For this case study, we'll refer to them as PMV. They managed approximately $40MM in assets at the time they retained us, and they could not have been in any worse shape:

1) they had been borrowing about 150% of their acquisition costs at an approximate average 15% interest rate, and

2) they were doing so by advertising the sale of fractionalized notes to the general public and taking in money from non-accredited investors.

For those who aren't familiar with securities laws, that is highly illegal. The result was that PMV was under investigation by three state administrators: Florida, Arkansas and Colorado, and Colorado had turned their case over to the SEC. To make matters worse, because of the extent to which they had over-leveraged their portfolio, they could not sell the properties for what they owed and their debt service way exceeded their NOI… they were unsustainably bleeding cash. This case tested the limits of our problem solving abilities, and it laid the groundwork for the depth and breadth of solutions we're able to provide today.

The good news was that despite PMV's total disorganization and infomercial sales and marketing style, they were raising about $5MM per month via note sales, with each investor… at least theoretically… tied to one specific property. This was an eye opening discovery as I had never considered direct marketing campaigns of this nature could be so effective in the domain of capital raising. I gained immediately clarity on the basis for "Blue-Sky Laws".

The first thing we did was have them suspend their capital raising efforts. While unwittingly violating securities laws can get you sued, doing so with intent can land you in jail.

Once we had them cease their illegal securities activity, we quarantined all the legacy properties under a single entity; replaced as much of the syndicated debt as possible (approximately $20MM in notes held by the most impatient "private lenders") with low interest commercial mortgages; and converted the remaining private lender debt to equity. This reorganization generated a substantial positive cash flow allowing them to complete the stabilization efforts of the portfolio without the need for additional external capital. Any shortfall of income to the private investors not recaptured at each property's exit was recognized as a note collateralized by PMV's future earnings. So while the private investors who were not taken out by the refinance did experience a delay in receiving their returns, only those who could afford the delay remained in the portfolio, and none of them received less than what they were initially promised.

After we had the initial fires extinguished and PMV completely removed from the securities issuance business, we split their business into two discrete operating companies with wholly independent management:

1) The asset management division became its own operating company with ownership wholly transferred to its management. We'll call it PMV Asset Management.

2) The division of the company that was previously selling private notes was relegated to what they do best — marketing and sales. We'll call it PMV Marketing, and they did not share any affiliated persons with PMV Asset Management. Instead of advertising the sale of securities, we had PMV Marketing implement an education-based marketing strategy utilizing Adagio's educational programs to teach the public about investing — specifically how to evaluate risk, return and liquidity — and guide their students to organize into investment clubs, which is not a securities transaction. Once the investment clubs aggregated $5MM in assets, they met the legal definition of "accredited investor" and afforded their members, regardless of their accredited status, the means to invest in private securities. Each investment club was then provided private securities offerings by one of our partner broker-dealers that met its specific risk, return and liquidity appetite.

As PMV was being reorganized, we created four funds with investment parameters that met all of PMV Asset Management's potential financing needs:

1) value-add equity,

2) bridge debt,

3) stabilized equity, and

4) permanent debt.

Shares in these funds were distributed through our partner broker-dealers. Each of these funds formed a general partnership with PMV Asset Management as a condition of receiving capital. This allowed us to ensure PMV was operating its business in perfect compliance with the terms of operations they presented. With these four funds in place, PMV Asset Management was not forced to sell their properties to the market at-large upon stabilization; each property was simply sold by the value-add fund to the stabilized equity fund, which kept the AUM under our umbrella. To make the stabilized equity fund competitive, we had the value-add fund exit to the stabilized fund at 2012-adjusted cap rates (approx. 10%), which insulated it from market risk and improved its performance. This structure accomplish several things:

1) We created four different risk-adjusted return and liquidity profiles to meet varying investment appetites:

    i. the value add-equity fund generated approximately 60% returns levered by the bridge debt fund;

    ii. the bridge debt fund provided a max 50% as-is LTV at 8%;

    iii. the stabilized equity fund yielded a secured and insured 15% levered return with a 60% LTV mortgage from the permanent debt fund;

    iv. the permanent debt fund provided a max 60% LTV at 6%.

2) PMV Marketing generated legal and legitimately earned compensation from educational services and investment club administration.

3) PMV Asset Management became a highly competitive multifamily operator by generating truly market neutral returns (alpha) for both a value-add and stabilized portfolio that far exceeded anything available in the public capital markets.

The final result for PMV was that they:

1) became compliant with securities regulations while providing retail investors access to four different risk, return and liquidity profiles, which better served market demand,

2) insulated their portfolio from market risk with substantially increased profitability, and

3) continued to raise capital and grow their AUM, but at an accelerated rate.

To learn more about how our investment banking services can benefit you, email us at *solutions@adagiollc.com*.

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