Ep #194: Greg Hughes - Hassle-free Real Estate Equity Investing

Full Episode Transcript

With Your Host

Dr. David Phelps

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David: Good day everyone, this is Dr. David Phelps of the Freedom Founders Mastermind Committee and Dentist Freedom Blueprint podcast. You're with me today and I'm going to have a fun interview. It's going to bring some additional insights into an area of real estate investing that a lot of people love to talk about. It's an area that they appreciate about real estate investing, but sometimes create some of the biggest, let's say potential problems for those who are not really in the day-to-day nuts and bolts of real estate investing. Sometimes what I call an accidental landlord.

So before I get too deep in the subject, because I start getting on a roll here, guess who I've got here today? It's Mr. Greg Hughes. Greg, Sir, how are you doing today?

Greg: I'm doing great, David. Thanks for having me.

David: Well, Greg's the founder and CEO of Hughes Private Capital. Greg and I met, oh gosh, a few years back. Actually Greg, I've known about you just because the

circles of real estate, people that are influential in the space, I think we hear about each other or maybe see someone at a conference. You do a regular monthly newsletter which you were kind enough to send to me and I always love to get your content.

So we've had a chance to really organically get to know each other and that's really the way I like to do it. I like to just meet people and just figure out where there's a commonality and that's exactly what you and I have done. We just spent some time here and there and actually had more time this last couple months to talk a bit more about the areas that we're both very passionate about and what you do specifically in the real estate sector.

So let me give a little bit more of your background. Greg's the co-manager of five real estate investment funds. Over the last 10 years, he's raised more than $86 million, has profitably bought and sold over 450, that's 450 single family residences in 22 states.

So a wide platform with a lot of experience, which I think definitely gives you credibility to talk about the pros and cons. A lot of people in the real estate investing space, particularly the people I speak to, Greg, being doctors, professional practice owners, they intellectually understand why real estate as being an alternative asset class, makes a lot of sense. Whether they're in the stock market or not, they know that being involved in non-correlated Wall Street products makes a lot of sense. And real estate is really the place to be.

It's like the question is how do you get involved in it? How do you invest your money in quality real estate without all the major headaches, that as I said, the accidental

landlord typically gets involved in? So we're going to talk about that a little bit.

Let me give you a little bit more information on Greg in and we will jump in here. Greg's taken all this experience that he's had over the last 10 years and he's offering really what he terms and I agree, it's one of a kind of solution for investors who don't want to deal with the hassles of being a landlord or even the hassles of managing the managers of properties, which is really what I tell doctors to do, not be the manager but have good managers.

But you still want real estate to be a part of your portfolio. And what we're getting the nuts and bolts of today a little bit, Greg, is how someone who likes the idea of the benefits of real estate, but has had problems, issues of the management side. Whether they're doing it themselves or someone else is managing. And that's going to be through one of the unique benefits that real estate provides, equity owners that is and that is the ability to do what's called a 1031 tax deferred exchange.

Let's talk about what that means. First of all, why is there a benefit to having an opportunity to move equity without paying the tax on it, Greg?

Greg: Okay. Sure. We can start right there, a 1031 exchange, let's just talk about how that works, right? So you have an investment piece of property, it can be any type of investment piece of property. And this is one myth that's sort of out there with people as they always think that they have to exchange one piece of property that's the same for the other, like a residential for residential. But you

don't. Just has to be an investment piece of property. That's all.

I always like to use examples, because it's the easiest way to do it. Let's say you bought a rental home 30 years ago now and you paid $150,000 for it. Today, it's worth $400,000, you've made some good money along the way. You've also had all the problems that kind of come along with that. And you want to get rid of it at this point, you're at that point in your life that you want to get rid of it.

But one of the problems is you're going to have this big capital gains tax, if you just turn around and sell the property. So what do you end up doing? Most people kind of just end up hanging on to them, but they still have all the landlord hassles that go along with that.

So the other one is go ahead and do a 1031 exchange and that's great, but now you're going to exchange it, which means you just buy another piece of property with landlord hassles. So why do that? And what we've come up within our fund of what we're doing is to be able to actually sell that piece of property, do a 1031 exchange and exchange it and meet all the requirements for the 1031 into our fund. But it becomes 100% passive investment, in this case.

So just going back to the 1031 exchange itself, if you sell that piece of property and you sold it for 400,000, you need to go buy $400,000 or more, so you have no capital gains tax on that. And then you kind of go through this deal of having only 45 days to identify new properties. And then you got to close in 180 days.

So there's this additional complication that come along with that as well. And it's another thing we've solved within our fund.

David: Good points you brought up. I see that often too is that while we're all about wanting to offset, mitigate, defer, eliminate, where we can legally, taxes on our investment assets, I see that tax tail wag the dog too often. I know you see it to where somebody just, to that same point, they want to do the 1031 exchange of property, whether they want to leverage into multiple properties or just go to another one. They want to move geographically to another area, that's maybe safer on the market, whatever the reasons are. They don't want to pay the tax. And that's smart.

That's smart because we know every time Uncle Sam comes in and takes a bite of our returns, our wealth building compound, takes a bite, it greatly reduces the compound effect. So that's smart thinking.

The problem is, as you alluded to Greg, is that the 1031 tax deferred exchange has rules to go along with it. And you have to, once you sell your property that you want to exchange and replace by other properties, you got 45 days to identify the next replacement property or properties.

Well, what's that do? It puts pressure on the … property, go out and find something. How easy is that to do in the marketplace today right now, where it's more difficult? Unless you really got access, if you got an access point, you're very active on the street today, where you can find those deals. But really to find a good replacement property today, in a short period time, very difficult to do.

So that's why I call it the tax tail wagging the dog and now someone ends up doing this thing, saving on the tax but did they really tax exchange into a better property or properties? Chances are, many times probably not, they probably didn't do so well.

And so now they're just back with maybe a worse return on property, at best the same, but as you said, now they still have the managing aspects. And what you've done with the guardian fund is you've created this opportunity for those who have currently rental properties that they've enjoyed, got the benefits and they still want to keep those tax benefits going, but not pay the taxes on selling a property. Now they can sell a property and actually transfer that equity into your fund.

Now your fund is handling everything. Now they don't have to talk to any managers. Your fund has a track record, it has a performance, that's something everybody wants to look at. We can talk about that, how many years the fund been goin? Probably a little bit of your insights into the current marketplace because as a fund manager, one who identifies properties, has to manage the managers as you do, what does that look like in the current marketplace where we're somewhere topping out here somewhere and how do you still find good enough deals to return the returns you do to your investor?

So I just blew out a lot of stuff there. So why don't you just pick whatever you want.

Greg: There's a lot there. Our little saying is be an investor and not a landlord. And really what that's all about is where you even started this off all the way back of being diversified, non-correlated type of assets. This is all for

the people that want to be, they want real estate in their portfolio, but they don't want the hassles of any of that.

So what we've done is we've gone out, we're in nine different markets in mainly America's Heartland. It's out in the Midwest, so to just give you some quick, so we're in Toledo, we're in Cleveland, we're in Memphis, we're in Birmingham, Jackson, Mississippi, we're in South Bend, Kansas City, St. Louis, Louisville, Detroit.

And one of the reasons that we're there is because we can find these types of assets, which are single family homes that are in the lower price range. So in other words, they're in closer to the $25,000 to $60,000 range. We call them affordable housing.

And we love this part of the market because of a couple things. One is these homes rarely fluctuate much up and down in value. I mean, first of all, it's hard to believe that you can buy something for $40,000 or $50,000. And they're nice little, homes I mean they're not brand new, they're usually older homes and they need work and we do that work for them.

But the beauty is there's not a big timing of the market on this. So I live here in Reno, Nevada, we went to a horrible downturn when everything turned. We lost as much as 60% value in our homes, now we're back up again, it seems like it's going well and I hope that it does continue. But we know it will cycle again somewhere in there.

With these little homes, because they are ... we like to kind of almost say they're compressed, so in other words, they can only get so low. And part of that reason is you still get a good rent ratio out of that. So the rent ratio is what's your rent to the value of the property?

So just to give you an idea, ours has got an average value of somewhere around 40,000 and we're getting rents of $600. That's a fantastic rent ratio. If I were to compare that to Reno today, we're buying something for 350,000 and maybe getting $2,000 a month out of that. And you're always trying to at least get 1% of the value of your home, if not way more. In this case, we're getting 1.5%.

So there's a lot of safety involved there, the other side of that is that these little homes we can keep them rented on a regular basis. If we get into a downturn in the economy, what happens? People don't upscale, they downsize, that's right. So again, staying in this affordable housing really helps us to stay in ... we're always looking to say what goes wrong with our investment, whether it's the economy or what we're buying or doing, whatever.

So all that's happening, you then add in the diversification of all of the different markets that we're in and that helps a tremendous amount as well on all of this. And in our deal, it is just a buy and hold strategy. We're buying, we're rehabbing them, we're getting a tenant put in them, but it's a buy and hold from there. We're not looking to turn around and try to flip or sell them, in fact we have zero appreciation built into this model. It is just based on cash flow.

Once again, giving us more safety with it. So we're not going to have any big wins, but we're going to hopefully never have any big losses either. It's just kind of this chug along, bring the rental income in, manage them, have the expenses go out and have a nice little net profit left over at the end of the month.

So that's what we're doing right now and the way that we're doing that with 1031s is somebody can sell their one investment property and then exchange that in to Guardian. And Guardian will, so let's just use numbers again, let's call it you sold your house for 400,000, you would exchange that into Guardian for let's call it 10 homes at $40,000 apiece. And that meets the 1031 requirements.

But the beauty there is that you come in to Guardian as a $400,000 investor and you get your pro rata share across all of the homes that are in Guardian today. So you're diversified across everything. Those 10 homes that you have your title on, your name on the title, doesn't really affect anything.

If those homes need to be repaired, Guardian repairs them, if one of them's vacant, it doesn't matter to you because you're diversified across everything in Guardian itself.

David: That makes a lot of sense. So if I take my $400,000 of equity from the sale of my $400,000 rental investment property and exchange that into the Guardian fund, as you said, now I've got title to 10 equivalent $40,000 houses but I'm the diversifed across the entire fund assets.

So two questions, how are my benefits, my equity and benefits particularly like depreciation offset? That assumes I've still got some appreciable basis in what I just tax deferred into. In other words, I don't want to get too deep in this, I'm sorry if I am, but the depreciation, tax benefits on depreciation are based on the basis of one has to own a property. So if I've written down a property

already and I exchange it over into Guardian, my depreciation is just going to be still based on a basis, whatever it was. So that doesn't change. I may still have a basis to depreciate, may not. I still will get that.

So I guess my question is, how's my net reported to me, so I report that on my tax return, Greg?

Greg: So let's just do it first without the 1031, because it ends up actually being almost identical. So you come into the fund, you put $400,000 in, that's your principal. And then you're going to collect your return and our return right now is around 9.5% to 10%.

David: I just want I want to stop right there. For people that are thinking about return on investment and whatever their parameters are, whatever their framework is for what that should be, I will just tell people right now, if you can go out and get 9%, 10% cash on cash return on investment on any rental property, whether you're managing or someone else is, just send me a letter right now and show me the facts. Particularly if you're doing it yourself or managing someone else, have you put your time involved in it? No one puts their time involvement into this stuff at all. They go whatever the number is, they brag and then they say, yeah, but how much time was involved? About four or five hours a month. How much are you worth four or five hours?

So I want people to understand, when you say 9% or 10%, on an equity fund with collateral of rental properties, see, that's a no-brainer to me. I can't go out and do that in my marketplace today in Dallas, Fort Worth. No way I can do that.

Sorry, I don't mean to interrupt you, but … clarity, who don't have a clue.

Greg: Here's really, actually, since you brought that up and we'll come back to what we were talking about before, because this is really a fun exercise. So here's what happens is, all these people have this money tied up in these properties. So when they first bought it, they went out got a loan and really when they looked at the return, maybe the return was okay, way back when.

But what happens is over a period of time, they build up all this equity and so what we're finding is people coming in and talking with us, it's almost rare that we can't double what they're making in net return. Sometimes as much as five, six, seven times, I mean it's incredible because they have everything tied up.

So here's the deal, I'll just use even a case study type of a deal. So a guy he says to me and we'll use the same $400,000 house, he says, guys, I'm doing really good. I said, okay, well, what are you netting now on the property? So we kind of go through the exercise and he says it's about $1,500 a month. So that's $18,000 a year, but you own the property free and clear, so that's $400,000. So to use super easy math, times 10% return, that's a $40,000 return inside of Guardian.

So you move from 18,000 including your time that you have to be all managed in it, to $40,000 in that case and it's so fun to talk to people about this stuff because it just happens all day long. So that's a really big deal on that part of it.

And a lot of times people make the mistake of saying, yeah, but I only have $150,000 into the house, but that's

great and you did well, but you have 400,000 sitting there not doing a lot. That's the problem.

David: That's the point.

Greg: I forgot where we were, we were talking about I think when you come in as an investor, is what we're talking about.

David: Go ahead and pick up there.

Greg: So if you come in as just a regular investor, you bring your $400,000 in you get a pro rata share of the net profits, that's the way that it works. So each month of course we produce net profits off of our rent, less our expenses and that happens.

In a 1031, the thing that's different is that you're going to have the properties titled in your name, however, those properties really don't matter. In fact, we don't even let people pick the properties out because it means nothing for them and they're treated again the same way. They're going to come in as that $400,000 investor, they get their pro rata share. It's just whatever their $400,000 represents within the total of the fund and they collect the net profits.

You started talking about depreciation, so in both instances, the investor is going to get a K1 at the end of the year, showing them the net profits they had. If they're a regular investor in no 1031, they're getting the tax benefits or the depreciation again on their pro rata share of that, on their K1.

So I always just again, use really easy numbers here, let's just call it they made $10,000, there was $4,000 in

depreciation that we get a write-off, so now they're only paying taxes on the 6,000. That's their tax benefit from depreciation.

David: So if I understand you correctly and again, I apologize to listeners if I'm getting in the weeds here, but this is just kind of for my clarity. So what you're saying is the actual basis that I had in my $400,000 property that I exchanged into the fund, that has no bearing on what ...

Greg: I'm not, no. So I was really doing it from just the regular investor coming in, not the 1031 and now I'm getting to the 1031.

David: I'm sorry, thanks. I'm with you, thanks for the clarity.

Greg: No problem, so now 1031 person hat, is in there, they're going to receive a K1 too. What's different for them is they're going to have those 10 homes that their name is on the title, specifically depreciating for them on their K1. That is the difference.

Now going back to what you talked about, if they've fully depreciated their other property, they're going to have a very low amount of depreciation they can write off. It gets adjusted or maybe they are 15 years into it and you've got some left. So there is an adjustment, they just don't get quite as much from that perspective.

David: What happens when I exit the fund? How do I exit the fund, especially if I'm an investor who exchanged a property into the fund? What's my exit, what's that look like?

Greg: So a couple things here and these are a couple more advantages on this, so you just got done selling one

house for 400,000. You now have 10 homes that are titled in your name, that gives you a lot of flexibility. You could come in and say, look, I want $80,000 now, that's two homes.

So what we do with Guardian is if you bought the homes for $40,000 a piece, we're going to buy them back from you for $40,000 apiece. That's getting you your principal back, so that's getting your money back out. Now you could theoretically go do another 1031 if you wanted to.

David: You can do a 1031 out of the fund… property.

Greg: You can do a 1031 out of the fund.

David: Interesting.

Greg: Or you could just pay the taxes, but the beauty is you only pay the taxes on the 80,000 portion. All the rest stays tax deferred on that.

So because we built no appreciation into this and we see this as being a very long-term fund, I mean 20, 30, 40 years, I mean what makes us not want to have this fund? We're not really sure what that is, so it's a long ways out, is that what we're saying and we'll just buy back. In other words, we'll give your principal back and of course you've made your return along the way, so you get that as well.

There's no lockup period in our fund either. Everybody has to realize it's an illiquid fund. So you come back to us you say, hey, I'd like to get some money out, it depends on your timing, it depends the amount of money. We're always trying to deploy our money, we're always trying to buy assets, because when it sits in the bank, it doesn't make anything for us, it dilutes our return.

So kind of the easiest way to explain that to people is to say, look, if you need 50,000 to a couple 100,000 out, we probably can do that this week for you. If you need $2 million, that could take three months, that could take six months to get out of the fund and get it back to you. You have to realize that.

David: And again, for people who haven't gotten down this in their head, I mean that totally makes sense. It's totally fair because you said, you've got to keep funds deployed, that's what your investors depend upon. And if you have to keep a big liquid capital reserve for people who want to come out of the fund, then you just reduce the return rate to everybody.

We all have to be in this together to some extent and realize that why we went to real estate investing in the first place was typically long term. We're not flippers, we're trying to invest long term, in this case, solid cash flow that your fund is able to produce, as you said, to any of us, very passively. I mean it's about as passive as you can get. I mean we're not having to sit with you at meetings and talk about property on Elm Street that ... sewer blowout or something. I mean we don't ever touch that stuff on the outside. I assume you don't either, somebody else touches it for you.

Greg: Yes.

David: So here's a question that I know some of my folks in Freedom Founders would want to know, I know you'll have a great explanation, but it's a good point to bring about. So I tell my doctors, Greg, that when they're investing individually in what we call turnkey rental properties, in a lot of markets you're talking about,

because I love those markets because they're the non-volatile markets. So right up your alley. I tell them that the property location and the property condition, age of property, that kind of thing is going to make a big difference on the management of that property, whether they're managing themselves, hopefully none are because that's ridiculous for a doctor to do that.

But it still makes it potentially more difficult for a manager, even a good management company to deal with, properties that would maybe be B-, C+ and again, for people that don't know the categories, again we're kind of talking about properties that Greg's talking about here in his fund, these are good properties in good working-class neighborhoods. They are older properties and they're definitely lower price points.

And for me personally, in my own portfolio for the busy doctors that I have in my group, I would not have them individually buy those properties. Why? Because number one, none of us myself included has built a machine that has efficiencies built into it. And that's the whole point I'm trying to make here is that what are the efficiencies that you've been able to build, again without giving out your secret sauce, but I know this is what makes your fund work in all these different marketplaces. I know you or your people have to manage the managers and mange the rehabs and manage all this stuff. That's what you're doing for us.

Are there any tips? Again, not that we're going to try and go and duplicate what you've done, Greg, I will never do that. Thanks for doing what you do, but how do you do it?

Greg: So you've got it right, used the right word there, it's a machine. I mean it is truly a machine and it gets better and better every day as we build the economies of scale here. So let me give you an example of one of the ways that we'll enter a market. So we'll go take a look at a market, we first examine all the assets. I mean we want to look at the homes, we want to see what we can buy, what our rents are, what our demographics are, is it depopulating or is it growing? All these things that you're looking at and all that.

Ironically, that's almost the least important piece of the puzzle sometimes, because of exactly what you're talking about. We will then enter that market and we will have made contacts with multiple property managers, so that we have boots on the ground, because we can't be in every one of these ourselves. And then we will start to test that market. But we're not really testing the market, we're really testing the property manager.

And that's really one of the big ways that we are able to be successful and we deal with this all the time, property managers not doing their job, believe that or not, can you even sort of believe that would ever happen?

David: I hear it all the time, unfortunately. Yes.

Greg: Surprise, surprise and then ones that are doing a really good job. When we get into those right markets and we have the right people because we have people that are here in Reno, in our office, all their job is to do is manage those property managers and make sure all of our properties rented and in line and rehabbed and all the things that need to be done.

So as we sort of build those economies of scale, that's going to get better and better. Then we've built a quite a sophisticated system, so that we can track all this stuff through obviously the computer. And we have a CRM that ties into our financial side of the business and eventually over a period of time here, we're going to be able to even give really good stats on how each property manager is performing.

But yet that's sort of the niche. One of the things that we feel that helps us somewhat in this type of asset is that most people don't want to do it. I mean most people go, well, let's see I can buy two houses, buy three houses for $50,000, buy one house for 150,000. I'll buy the one and I mean if I was just the person going to do it myself, it's probably what I would do.

It's hard. It's hard to manage three properties as compared to one. So that gives us a little bit less competition, but it also gives us all those other safety features that come with that. A higher rent ratio, less fluctuation in the pricing of the home. That $150,000 home will go down in value when the economy turns, even if you're in beautiful America's heartland out there. It will change. These other ones, they just don't go up and down much.

That's how limiting that entire deal of trying to time the market on these things, which is just scary when you think about it, because if you're buying a house here in Reno, your timing better be good. Because it will bite you if it's not.

David: Exactly. Very good, last question, Greg. I know people are going to wonder about this, can a self-directed IRA invest in the Guardian fund?

Greg: Yes, 401s can as long as they're not active. We can help you to move stuff into self-directed IRAs, so if you're not used to doing that, but yes and I do that myself and my partner does that and we've got lots of people.

David: All right, very good. So Greg, for follow-up, the best website domain contact would be 1031yourrental.com and that's the numbers 1031 or 1031, that stands for the 1031 exchange. So 1031yourrental.com.

You also have some additional contact information. Do you want to provide that here? We'll put links in the show notes, of course. What else do you want to give out for people who want to contact you about the fund or anything relevant to our interview today?

Greg: I think that's a great place to start. You're obviously welcome to just go to our website, which is hughescapital.com as well, but I think if you go to 1031yourrental.com, especially if you're thinking about 1031, that's going to be a little bit more specific and take you from there. And of course you can get anywhere you want to from there, on that.

So they'll have contact numbers and everything else on there.

David: Perfect.

Greg: And if people go there and you're interested, we've got what's called an investor kit, we can send that out to

people and be more than happy to of course go over the whole program.

David: Outstanding. When you and I talked about this a few months ago, I knew there would be great relevance for people who enjoy the aspects and the benefits of real estate investing, but I just want to take more of a hands-off approach and have a place to move some of their current properties in without paying the tax. And you've created a very unique positioning in that regard and I thank you for coming on today to talk about it.

I think it definitely will pique some interest and provide some valid opportunities for people who still want to stay involved in real estate investing, but don't want to have the hands-on approach.

Greg: Thanks for having me today, David.

David: Absolutely, been a pleasure Greg. You take care, we'll talk soon.

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