Ep #330: Lance Pederson - Trust But Verify: The Key to Due Diligence

Full Episode Transcript

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Dr. David Phelps

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David Phelps: Good day everyone, this is Dr. David Phelps of the Freedom Founders Mastermind and the Dentist Freedom Blueprint podcast. Today we're going to go down the rabbit hole a little bit on how you as a potential real estate investor in alternatives, and more specifically as an accredited investor, which we will discuss here with my guest today who is Mr. Lance Pederson. Lance, how are you, sir?

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

David Phelps: You are the founder and managing partner of Verivest, an end-to-end real estate investment platform designed to bring transparency and trust to middle market investing. You're also a principal in Fairway America, a real estate private equity firm, as I mentioned, in Portland, Oregon. You were also the co-founder and CEO of Convergence Networks where you pioneered the IT-managed services provider business model. Convergence was one of the fastest growing companies in Oregon and is annually recognized by its employees as one of the best places to work.

You currently live in Portland with your lovely bride of 19 years and five children. Working with Fairway, with your background knowledge, what were the issues that you with Fairway were always trying to deal with? How did Verivest arise as a platform today to deal with some of those concerns and challenges?

Lance Pederson: Sure, yeah. Happy to get into it. I think to go back in 2012, Matt Burke and I we sort of pivoted our company, Fairway America. We were historically a commercial hard money lender in the Pacific Northwest. We found it more and more difficult to find deals we were willing to do, just the LTVs that we wanted. We realized that we want to move up a click and be equity investors and really become more of a private equity real estate firm and raise capital from investors, predominantly high net worth, and allocate it into worthy sponsors around the country executing strategies that we felt were going to deliver an outsized risk-adjusted return.

That was the working model. What came out of that was that we learned quickly when we tilted up our first discretionary vehicle fund to allocate into these things, is that the underlying reporting of the sponsors was becoming a hindrance. I mean, we couldn't report at our fund level with the quality of the reporting that we were getting. We realized there's this reporting problem. An accidental business was formed out of that and we realized that we had this advisory practice where we're helping people form pooled investment vehicles, and then we had our own investing activity.

It became very clear that in all cases, the thing that was stopping the capital formation and to fund deal flow was really this reporting problem, financial statements, and capital account statements and all those sorts of things. We took an internal department and made an external-facing division, and we started offering that as a service. Here we were now suddenly freed up that constraint and in 2017 we spun that out as a separate company, which is, Verivest. We're really a service provider to this middle market, real estate space whether you're... because there's an ecosystem, there's guys who lend money to developers who develop, there's guys who reposition and value add. It's all interconnected.

Well, as investors ourselves, what we realize is that when we find a sponsor that we think has an interesting story, and it fits our mandate, we feel like, "Well, we need to vet these guys. We need to start with them and we need to dig deep and figure out if they got any skeletons in their closet. We need to understand their track record, is it legitimate? Then, not to mention, if they've got a deal, go down and dig into the deal level and figure out if it's a deal that makes sense for us to do, whether it's a fund, or a single asset syndication, or joint venture. But what we realized is that the time involved with doing that was great.

We, like any investor, I mean, at that point we're just a super investor. We got more money to allocate and maybe more resources, of course, to conduct that diligence on the sponsors. But what you realize is that, you're saying no to potential investment opportunities because you don't have the time. This is where I think it's for all those who are looking to invest passively, have that... it's that moment of time where you're like, "I know I need to do more. I should be doing more digging other than..." when you talk to most people, what they say is they use time as their barometer, "I'm going to meet someone today and I'm going to wait six months, nine months, a year before I decided to allocate to them."

To us, we saw that. We didn't have that time. We wanted to allocate capital. We had money, we wanted to put it to work, so we had to solve it. Which meant that we had to increase our resources and those things. Of course trying to get someone that you don't even know if you're going to invest in them to pay you money to do it upfront doesn't really work. I think when you fast forward, we saw that that's where there's a lot of friction. What I call it is I call it, it's the time to trust because that's really what's happening. The transaction it's, how long does it take me to decide that I trust you?

Now, most investors end up getting not all the way there and they just have to use their gut and they use this time thing to say, "Okay, well, I'm comfortable. But what I heard from investors, mainly passive investors, those who don't have the kind of buying power that we might have at Fairway America as an example, is that over and over and over again they would share that, "You know what I really wish? I wish I could run a background check on some of these guys that I'm doing deals with. Because they seem great, and they look great, and they're nice guys, and we get along, we play golf together," whatever the thing is.

Then they also say, "But you know what I'm also secretly terrified, is that I've invested in a Ponzi scheme." When it's going well and they're getting checks, instead of being so happy that they got this money they're left with this, "Man, I just hope that this thing isn't just some Ponzi scheme," because for them it puts them in this vulnerable position. Which I think also is the reason why not as many people participate in this space is that it's so intimidating. It puts you in this position as a passive investor where you end up feeling dumb, you feel like you don't know.

You know real estate guys, I call them deal junkies. They just love deals. But they speak this language and this lingo and it's intimidating. They're not even aware that they're doing it. So then when you combine that with the fact that no one... they're all under the regulatory, they don't meet that SEC requirements. Really it is what you refer to as the Wild, Wild West. There's really no oversight per se. Even the stuff that does exist like audited financials or whatever, they generally are not... they're just trying to make sure the financials adhere to GAAP or IFRS or whatever, not necessarily trying to dig up some fraud.

Anyway, you've got these investors who, these are the concerns that are on their mind and I kept getting that feedback. The challenge we had with, how do we just get in deeper down the funnel with these guys? It dawned on me, I mean, all of our clients on our side, their biggest constraint was raising capital. They're like, "Number one constraint, just don't have enough capital to fund my deal flow. Just building relationships." That's when it dawned on me is that it's, you can't remove the fact that it's a relationship that's formed and the transaction is trust.

If we can, from where we stand, is this independent third-party I call Switzerland and the ecosystem, which we are short of the conflict that we have with Fairway that I have.

I manage that conflict. But I'm like, Verivest needs to be neutral. I'm not going to say, that's a good deal or that's a bad deal. Because the second that I do that, now I have to curate down to the deal flow. My thought was, look what Amazon did and these sorts of guys. What we really need is we need one place that people can go where all the sponsors are listed and you can filter them by your own mandate. "I'm looking for multifamily syndicators in the Sun Belt." You can drill down and go, "Here's the universe."

Then, my thought was that if I could have these sponsors pay for us to run the background check on them upfront, and do so annually, and sign a code of conduct that says, "If I get into trouble in between those two points, I'm going to notify you, and if I don't I'll be delisted." You've been removed from the network. That should help shortcut that. Then these track records that many of them especially, they all say... everyone wants to make claims, "I've done $500 million worth of loans. I've bought half a billion dollars worth of real estate." My take in the world we live in today is that, you turn on the news and you take any information, none of us trust anything anymore. We just don't.

I mean, I remember when I was younger, maybe it's because I was a kid, but I mean, I turn on CNN, I just believe what they said. Maybe that was just me in my youth, but I'd to believe that they were more... at least Dan Rather at 5:30 on the CBS Evening News was telling me the damn truth.

David Phelps: Let me give you a tip. You have to go back before Dan. It was Walter Cronkite.

Lance Pederson: Walter Cronkite, right? A trustworthy guy. I'm getting it straight. I think for me that was the whole thing. It's like, if everyone's making claims, if someone could stand in there and validate and verify them, we can allow those who are upstanding people, who are willing to be transparent, and give them a platform to be discovered, shortcut that time to trust. Then the other thing it's, put a video on there. Because, once again, you want to call people and you're going to ask the same questions over and over and over again, it's just a waste of time. So hit play, listen to 15 minutes where we ask them the same seven questions you're going to ask them to go like, "Do I like these guys or not? Does this make sense for me?"

Now we're getting people deeper in the funnel closer to making investments, and I think just removing some of that friction. Then obviously I think a lot of new participants make it easier for them to participate. Then fundamentally it comes down to, once you've gone through the sponsor level due diligence and you feel comfortable with them because you know that someone's paying attention on an ongoing basis. That was the other key. It's great that they weren't a criminal up to that day and didn't defraud people or be caught yet. But to me, it's what happens after the investment's made.

Having been administrators now for the last eight years, we just follow the money. You follow the money. As the money moves out, mainly outbound money, where is it going? There's this operating agreement that the limited partners and the general partner have agreed to, "You can't do this and you can't do that. You have power to do this and you have the power to do that. You're going to get a fee of X based upon this." To me it's like, watch the money going out. We collect bank statements, we get the general ledger detail that shows everything that was entered into the ledger against the money that went out, the financial statements. If they say they acquired a new asset within that period, show me a closing statement. We'll review that against the public record and triangulate all these things.

I'm going to make sure that wherever that money went, it was supposed to go there and it's for the amounts that should have went, because that's just... if we do that for all the investors that are invested, now they can focus on some of the other issues like, how's the business plan going? Is occupancy trending up? Is the absorption rate going well? Because let's face it, those are the things that I think everybody would rather be spending their time on, but the other stuff's a distraction. That's really what we're doing, it's like anti Ponzi scheme insurance. For us, if someone decides to do that, the fee is is negligible. I mean it's three basis points of the capital or whatever, and then investors know that the things they're seeing have been verified.

When they say that these guys are managing $100 million dollars. Well, we know, down to the penny, how much money has been put in their stuff. It's not 2X that because they're just fluffing it up to posture. That stuff is rampant and to be honest, I'm just tired of it. I'm just flat out tired of it.

David Phelps: Just in review, Lance, and that was a great, great summary. Thank you very much. In review then, for a deal sponsor to be Verivest-verified, then there's two components. There's the initial background check and track record, but then there's the ongoing monitoring. Now, is it two separate parts or is everybody who's a part of that, is it all together in one thing? They can't just get verified and be part of that or do they have to have the monitoring for ongoing deals? How does that work?

Lance Pederson: Yeah. Great question. Yeah, when we consider a sponsor Verivest-verified, that's the lowest bar and that's basically the principals of the firm have passed a background check. They don't have any personal or business bankruptcies in the last seven years, no lawsuits alleging fraud, no regulatory sanctions, the SEC hasn't barred them from selling securities, no felony criminal convictions, and they've signed the code of conduct. The decision of whether they pay us to verify their historical track record is up to them. This is like, I'm a big free market guy.

If your competitor, at the end of the day you're all competing for dollars, has decided to take their historical track record and have us verify it and make it publicly accessible for investors to see the depth and breadth of the said track record, then you're at a disadvantage if you're trying to sell the same thing. If you're both multifamily syndicators in Charlotte, North Carolina, most investors are probably going to go with the one who's decided to have their track record validated rather than just providing a PDF. That's their decision. But step one is that we won't verify the track record of someone who hasn't passed the background check.

Then the monitoring is separate. We go down to, you've got X number of investment vehicles that have been spawned that have so much investor capital at risk in those deals. It's more of a, if you've engaged Verivest to monitor 100% of those vehicles, then you attain this new status in our system, it's basically a gold badge. Now in the search order rankings, all of the gold badge people in order of investor capital managed high to low, you're going to rank higher, so you're going to be discovered more quickly. Let's say that you've only engaged us to monitor two of your deals but the other 10 we don't see, then you'll get a percentage of 20% of your deal.

What we're trying to do is we're trying to really get... we realize that a lot this stuff under the hood, there's a lot of data, a lot of information, and it's a process. Because for many of them, it's not a matter of they've made some conscious decision that they don't want to be transparent. It's really more of a function of the organizational maturation. Their ability to, I mean when you think about it, even get to a point where they're able to provide quarterly financials. I know it sounds ridiculous, but there's a reason why many of the single assets syndications you've invested in only give you a K-1.

It's because what happens is that the property manager is producing something that looks like a monthly financial, but more often than not it's missing a few things. It's not finished finished. To close that gap for many operators so they don't have the resources to take what the property manager came up with and finalize it. For us, that's our way of saying, "Hey, you might not be there yet, but let us help you get to the point where you can consistently report to your investors financial data on a quarterly basis with some kind of narrative and get you in the bounds of what investors expect." Because what investors want is, "If it's a K-1, then give it to me sometime in March, I don't want it in June."

It's like, "I want a capital account statement on a quarterly basis so I can see what's my tax liability and where is my capital account. I want to see the property level or the financials for the deal that I'm invested in. I want a narrative report, maybe do a conference call so that I can ask questions." I mean, that's the gold standard but so many people are away from it. For us, that's really what it's about is transforming and creating a forcing function for the market participants to start to make this look and the experience to be more similar for investors getting involved instead of...

Because right now a lot of guys run around and one of their big differentiators is, "We report quarterly," like that's a differentiator. "We've got an investor portal." I'm thinking, "That's not a fricking differentiator, that's a table stake." You know what I mean? You let your investors, limited partners have access to information about the equity investment they made? That should be required, not optional. Because that's what creates this fear and people are like, "Man, I hope everything's going okay." That's just not a good user experience.

David Phelps: That's right. That's right. You said this already, but I want to just reiterate this point, that with the background check track record and then the ongoing monitoring, you are in no way establishing the merits of a specific deal. In other words, you say, good deal, bad deal. That's another conversation you said, really is where an investor needs to learn additional questions to ask and do additional due diligence, market analysis, other metrics they might look at to determine for themselves whether this is a good deal or not. Correct?

Lance Pederson: Yeah. Most definitely. Yeah. I mean, I think that that's, it's like any investing, whether it's in the public markets and you're deciding to buy a stock or not. I mean, a lot of people of course lean on investment advisors and those who point them. To me, that's what's happening is that they're saying, "I think that this is the appropriate investment for you." You either decide to engage a professional to provide you that advice or you decide to do it on your own. It's DIY investing. If you want to do that, then you're going to need to learn how to do it, which is why I've got my own podcast called Real Estate Risk Report, and that's what we spend the time talking about.

My day job is Switzerland and the ecosystem, my side gig is trying to help people understand how to become better real estate investors. How do you dig in and what are these risk factors? How do you assess whether something's good or not? Now, as you know David, I mean, there are market participants. This is what I believe is, as this middle market real estate ecosystem matures is that, what's happening is you're starting to see a group of people, it's private equity real estate is ultimately what is, but it's micro, where there's these people like Mike Slotnick or even us on the Fairway America side. Where they're really, really good at determining whether or not an investment is worth doing.

It creates this really good tension. That's why we've intentionally not wanted to step into that spot because what that's called, that's called every crowdfunding site out there. That's called CrowdStreet, that's called

RealtyMogul, because at the heart of it that's what they're doing. The service they provide to their investors who invest through their doors is they're saying, "We've taken it down another notch and passed judgment on the deal, that it meets the merits of the deal level with our experts." But to me, this isn't an industry where there can just be five groups that control all the deal flow.

If it's not happening in private equity or it's not happening in this other venture, it's certainly not going to happen in real estate. Real estate is fragmented and the fragmentation is a feature. That means that, there's so many deals that are going on and to have people on the other side of the table, from the operators themselves that are basically pushing back against their assumptions and forcing that rigor, that's good for the industry. Then that allows those who are truly passive, who'd rather play golf and not learn how to become the world's greatest at analyzing real estate deals, that's what's going to happen and that is what's happening.

The doors and the access to product. I'm not here to say I'm fully democratizing real estate. That's not my intention. My intention is to allow it to function more efficiently. My belief is that, that means that operators, it's hard to go find deals worth doing and it's hard to execute business plans on deals. Because it's local, that's enough work on its own. Having to build 500 net new relationships with individuals to get them to invest when they need them to invest money is just a bit of overkill.

What's better served is for those to develop their own little tribes or following who believe in the way that they assess and look at deals and say, "I trust that guy's ability to scrub down at the deal level and figure out this is a good deal or not." I think that just creates more healthy tension throughout the whole ecosystem. That's my opinion and that's what I'm trying to further.

David Phelps: Yeah, really well said. All right, I'm not going to push you too hard on this because this is not the point of our conversation today. But we both know that in long bull run market cycles like we've had coming out of 2008 recession last eight years, we've even had a dip with COVID back in the early spring of 2020. We won't get into the reasons why things got pushed back up again, but there's a lot of artificiality to that. Why would you say to me or anybody else who is more on the outside, more of a passive investor, love real estate. There's this... well, my point is, Lance, there's a lot of market euphoria out there. You would agree.

Is this a time when it's more important than ever when we're at this kind of, some of the market where there's got to be an asymmetric risk out there today of really knowing where you're putting your money today? Because again, we're talking about, for the most par, operators who have some good track records, but how far back do they go? What's their knowledge base? What have they gone through, and what's the foundational aspects of their ongoing operations? Just maybe give me some context there.

Lance Pederson: Yeah. No, I completely concur. I think that, that is the issue. Is that when you have the vast majority of the market participants were born out of that extended bull run from 2009, 2010 through into 2020, right up to the pandemic. It's that, yeah, I mean, everyone looked like they were a genius. I think that now it's trickier for many of them now to navigate this new world. I mean, even this morning, I think the Wall Street Journal was just talking about, because there's been a lot of multifamily more than any since even post-COVID here. Has been sort of really, really, really hit hard with everyone hyping it up, "Multifamily shelter," blah, blah, blah.

Wall Street Journal is coming out today and you've got to take some of this stuff with a grain of salt, but they're like, "Okay, they're starting to feel the effects now, landlords and operators, it's not all rosy." But once again it's like all this stuff has to be taken with a grain of salt because if you're talking about New York City, or San Francisco, or whatever, yeah of course. Those dynamics are not good for those who own properties there especially if they bought them in Q4 of 2019. You're going to see that. But I think that those who have been in the game more than one real estate cycle will tell you that, "You know what? This is what happens all the time. If it's not... this time it happened to be a pandemic, but this is how it goes all the time."

That's the reason why I think that, "Yes, background checks and monitoring and all that stuff." To me, that just keeps people, that just keeps them honest. That's the trust but verify thing. When you have to make a hard decision, now you can't go and decide to sweep it under the rug, you have to address it and I think that's good. But ultimately those who are controlling these investments, the skill required to navigate these markets, especially ones, that falling knife, which is what we can expect because that's how other markets have operated. It really does become important to figure out what their strategy is, and how they're doing it, and the markets they're operating in.

Because you did see on that run-up where it just seemed like a lot of people were reaching further out of... there were basically armchair firms who were buying properties in places they don't live and don't necessarily have a lot of investors who are not local to the market. I think that for me that's how I look at it is that, this is just my personal opinion, but I just think that finding people who have their ear to the ground in a given market. This, once again, just makes it all the more important that they are true peer play operators. I mean, fundamentally, someone who's controlling that asset. Wakes up in the morning, all they care about is finding good deals and executing business plan at the deal level.

They're going to be the ones, I think, who have a much better chance of navigating this environment and still generating value. But yeah you've got to be very, very, very careful when you're an investor. If you see anything these days saying they're going to generate on a value-add play, light value-add, or whatever, some IRR, that's just fiction. I don't care what fricking market you're in. It's just, you just have to be more careful. That's why for me I look at it like, a lot of the stuff people are worried about when they're assessing deals was that noise. I'm trying to eliminate that noise in Verivest to create signal.

Because what you should be digging into is down at that level and you need to stick to yourself, "Here's what their plan is. Does this make sense?" Converting Residence Inns or Ramadas that are just workforce housing multifamily. Well, I like that, it sounds like a good strategy because those assets have been stripped of everything. There's a shortage of housing and now affordable housing. That strategy makes sense. Does it make sense in every city? No. But there's certain markets it does make sense. It's just, I think that's how you have to look at it.

David Phelps: Yeah. Really, really good. Lance, gosh, I appreciate your time. It's always fun to talk to you. You have so much experience. As you said, it's a fun industry to be involved in. It's a fun place for people like me and the people that are in our group to be able to invest. We get to do a lot of things vicariously, but we are going to be sure we're doing them vicariously through people who know what they're doing. That's the fun part. Real estate is fragmented and that's where the opportunity is. It's not a nationwide marketplace by any means. Knowing what's happening on a peer-to-peer basis is the key and having access points and people like you who have set up platforms and the opportunity for passive investors to gain a level of understanding, and knowledge in metrics, and some level of assurance of the people they're maybe dealing with is the key here. Appreciate your time, Lance Pederson.

Lance Pederson: No, more than happy to join you anytime, David

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