Ep #337: David Phelps - Lessons on the Street

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Dr. David Phelps

Dentist Freedom Blueprint with Dr. David Phelps

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David Phelps: Hi, it's David here. As I told you in the last week's episode, I am going solo for a few episodes. I might still mix a few different interviews in between, but I felt like there was so much happening right now in front of us in terms of the economy and politics and what's happening that I want to give you a little bit more of my insights and foresight and what I see coming, and some of the lessons that we constantly have to look at that we have the opportunity to learn, but many times we don't see what those are. We don't put ourselves in a position to see what we can actually learn from being in different environments.

The key to my overall evolvement from being a practicing dentist to being really very free in my life and doing really what I love to do today and enjoying the people I get to be with, doing it the way I want to do it, where and when I want to do it, which is what I describe as true freedom, didn't happen by accident. But it also didn't happen because I had some absolute, defined vision of where I wanted to be. There was a culmination of a number of things that happened, and I want to provide some of that to you, but also through the eyes of another place that I was this past weekend.

Again, there's a story behind the story here. Our Freedom Founders members often go on what we call due diligence trips. These are trips where we go to the site where some of our trusted advisors, the people who bring us the real estate investments, highly curated, vetted, due diligence, underwriting are done, well, this is an opportunity for our members, whoever wants to go, to go onsite for two or three days and actually become embedded inside the culture and business operations, the model, if you will, of what this particular real estate sponsor or manager does. In Freedom Founders, we have a wide spectrum of opportunities with which we can invest, provides diversification within the asset class overall, real estate.

And if you have been following me at all, you understand that there are different ways to slice the real estate investment. Most people think about real estate as being front loaded as an owner, an owner of properties, very simply owning a rental property. That could be step number one to somebody's involvement in real estate. And it's not a bad place to start, but too many people start there. And because they don't have an understanding of how to do it, the right way to do it, the moving parts, the pieces, the contractors, the acquisition, the tenant management, the financing, they step into a world that's unbeknownst to them and unfortunately make some mistakes.

Now, sometimes the mistakes are not so bad that they don't pick up the pieces and do a better job. But in Freedom Founders, my job is to help our members not fall into that trap, not fall into the do-it-yourself trap, but find people, am environment, a community in this case that have already gone down that path and really create the actual implementation along with a guidance to do it right. And then if someone wants to go off and do it by themselves after that, then they have a clear pathway. They've got direction. They have a model that they can follow and keep them within the guardrails.

So anyway, this last weekend, we were actually in the Big Apple, New York City, looking at a specific real estate model where we can participate in the investment. Now you might be thinking right away, "What kind of real estate are you doing in New York City? I mean, my goodness, hasn't the pandemic just about eradicated New York City from the planet?" Well, the media might tell you that. It's not that bad. In fact, I will tell you, number one, if you're listening to the media very much at all today, that you're getting a very slanted view of what the world and the economy looks like. It's just is what it is.

And when you actually really go and see what the real stories are, what's really happening in different places of the country, of the world, you find that most of it's hyperbole. Now, there's certainly some substance to the stories that the media tells, but in this case, New York City is strong. Now I'm not saying that financially that they're stronger or the country's strong. There's certainly a lot of debt, but not withstanding the people. I'm talking about the people, the strength of the people. If not for the government in the state of New York, which came down really, really hard on that state. And other states had the same thing happen where the governments had much stronger lockdowns, and in my opinion, just my opinion, create a lot more upset and disruption in the economy than was necessary. But that's not my point. New York City is strong. The people are out. They're just as sick and tired of the shutdown as anybody else has been across the country. And things are picking back up. The state, the city is very vibrant and no doubt they will come back strong as they're already showing.

So again, the question is, "Well, David, why are you looking at real estate investments in New York City? Sounds like that might be expensive. It might be very risky." Well, here's what people don't understand is that as I was saying earlier, being involved in real estate doesn't mean you have to own the real estate. There's what I call control without ownership. It's a big piece of what we do in Freedom Founders, and there's a place for it. Rather than own the real estate, one can own the debt. In other words, be the lender, be like the bank. Own the debt. Owning the debt secured by the real estate is a much safer proposition than actually owning the real estate, particularly in a marketplace like we have today, where we have asset bubbles both in the stock market, Wall Street, and surly in real estate.

The thing I like about real estate is that it's a very inefficient market, which means there are pockets and locales and geographic areas and asset classes and price points where we as the individual, the retail investor, can position ourselves where the big money cannot play. If you want to play with the big money, you go to Wall Street and you play in that arena, or you can buy REITs, real estate, investment trusts, which are all correlated to the stock market. And again, it's big money. I don't want to play with big money because big money rides the market overall and I think the market overall is set for a correction, primarily in the financial markets. Real estate will also feel that, but as individual investors with broad diversification and a pulse on what the market's doing, we can actually orchestrate our finances. So we're looking at owning debt.

Well, you might ask, "Dave, what kind of debt are you talking about? Why aren't the banks making loans to the creditors in this case that are... actually, to the debtors who are wanting to borrow money based on the real estate?" Well, what happens is there's a general generational wealth issue, a transfer issue. This happens across the board, but it's seen widely in places like New York City where there's a lot of wealth, a lot of generational wealth. And what happens is one generation is the patriarchs and the matriarchs are the ones who actually create the wealth. These are people who are immigrants, people who come, in this case to New York City. It could be anywhere in the country, but in this case in New York City, and they start a business, and many times, that business has a real estate base.

So we can go back 60 years. In fact, there was one example where there was a couple who came to New York City as immigrants back in the '60s, put their savings together, put it together and started a French restaurant, and over the years built it up, actually were able to buy the real estate eventually that housed the restaurant, and for decades continued to increase the revenue, the profit, and created some substantial wealth for that particular family. Now, some 60 years later, 2021, two brothers who inherited the wealth from their mother and father are now at heads with each other. And they're butting heads because they don't agree on the direction of what to do with the wealth. And one wants to do one thing. Bottom line is they borrowed money against the restaurant, against the real estate, and now they are in default on this real estate. And the default interest rate in New York City happens to be 24%. So as you can think about it, the compound effect of that adversely affects the equity and steals away, erodes the equity very quickly.

Well, the trust advisor that we spent time with that makes a market in New York City actually buys this, what we call non-performing debt, buys non-performing debt. Now there's a whole structure of how to do this, and I'm not going to go into the weeds of that today. That's not the point. My point is that there are niche opportunities in every market in real estate to do what we call protect our downside, the downside risk protection. And that means how do you look at the risk of what you're buying? We think about it, in being a lender, think again, a bank.

When a bank loans money, typically, in this case to commercial borrowers, the bank doesn't lend 100% of the value of the property, do they? Usually they'll lend up to 70, maybe 75% of the value, meaning the buyer, the acquirer of the property has to put down 25 or 30%. That's what we call hard money. That's called skin in the game. And that protects the bank so that if the borrower goes into default, doesn't manage the property well, doesn't manage the business well, that there's some equity margin, 25 or 30% above what the loan amount was based on the market value of the business or the real estate.

Now there's certainly going to be legal costs, collection costs, that sort of thing that has to be built into that reserve in the equity margin. But think about it. The bank is going to be in a better position overall generally in protecting what we call the downside risk because the banks in that better position, we call it being in the top of the capital stack. It's a common word used in real estate. But the bank is at the top of the capital stack, which means the bank gets paid first.

Now, when a loan goes into default, the bank that made the loan, that originated the loan, doesn't want to be the bank that actually goes through the collection process. Those originators of those loans are not in that business. They are in the business of making performing loans, where the borrower pays them back and the bank receives the interest, and then uses that to make additional loans. That's a typical type of bank institution. That bank does not want to go through foreclosure and go through the default process. It's not their business and they don't want to have a reputation of being the aggressor in these cases. So what they do is when there is a non-performing loan that's gone into default, these particular banks will as quickly as possible want to sell that particular loan, the defaulted loan, to another company who then takes that loan and goes through the collection process.

Well, the trust advisor, the real estate partner that we are affiliated with in Freedom Founders for this particular model, makes a market in New York City for buying these non-performing loans. And of course, they don't buy them at par. They don't buy them for the existing unpaid balance. They buy them at a discount. They're taking off something that is non-performing and that the current bank doesn't want to manage. And by buying at a discount, it gives them what? It gives this company more margin.

Now we in Freedom Founders were able to participate, which is a big term that I use in my vocabulary, because that's the way we can be passive. We can take participations. The key is who are you taking participations with? What's their track record and what's their model? In this case, I love the capital stack by buying debt, by participating in with those who actually buy debt, in this case, non-performing.

Now the key is what do you do with non-performing debt? Well, this is what the company does. They've had a market in New York City in doing this very business for some 30-plus years, and it's all about the relationships. I could not go to New York City and do what they do. Number one, I don't have the experience. I don't know the market and I don't have the relationships. Three key areas of why I love to be a passive investor in real estate and where the returns on our investment can be way into the double digits because of the opportunity. It's a niche opportunity.

It's an inefficient market. Big money can't play here because big money has too much money to invest in. They have to put it out into wider market spreads. By being in a boutique arena with boutique players in certain niche markets, we have the opportunity to participate and make very, very significant investment returns.

Okay. So where do the lessons come from in this case? So the initial originator of this business, this company back in the '80s was or still is an attorney trained in the practice of law. But instead of going into what I call standard law practice, where one might specialize in family law, or maybe it's personal injury law or many different subspecialties, actually created a niche through relationships that he had made over the years into the financial markets, particularly into making loans, first by making loans, originating loans to consumers, and realizing relatively quickly that that was a very painful group to work with, painful because it was hard to go through the collection process on defaulted consumers. It's hard. It's difficult. And there are many laws that prevent the creditor to take strong action.

So very quickly, this gentlemen, this lawyer moved his practice, re-niched it into the commercial space. So investments in wealthy people. Niched it there and found that that became a business that through relationships, he was able to buy nonperforming commercial papers, we call it, secured by real estate, from a lot of different banking relationships in New York City.

Now, of course, he knows the market. He knows the market. He knows the people. He knows the players. He knows what the value of these properties are, and therefore what to bid on these non-performing loans. Bottom line is they've made this niche business. He loves what he does. He talked about the fact that in life, you want to remove as much negative energy as possible.

And think about it in your own life, your own business today. What's draining you? What, what behaviors, what people are you working with, vendors are you working with that just drag you down on a regular basis? I'm not saying that we don't have challenges off and on here and there, but if you're systematically being taken down in your energy levels repeatedly by the same type of behaviors, actions, or interactions with your patients, your customers, your clients, and also the vendors you're seemingly forced to work with because that's the model you chose, then maybe it's time to make a different model move.

We talked about the fact that by reducing that kind of friction or what I call drag on your daily work, your business model, your profession, you can extend your timeline much greater and it creates space for you to remove the negative energy means that you now have created space for the positive energy. And when you have positive energy in your life, you're thinking ahead, you're thinking proactively, "What can I do to enhance the impact or enhance the business model, enhance the profitability by again, selecting, being focused and having clarity?"

Too often in life, we go through learning through our formal education to go into certain business careers, professions, because this is what we're told we're supposed to do. If you are self-selected by being able to do well on tests, for example, and have a propensity for mathematics or engineering or whatever it is you do, then you follow a pathway into a certain career path. I'm not saying it's bad, but the problem is we follow industry standards and we go by the model the industry shows, and it becomes also oftentimes a commodity so that we can't differentiate what we do.

If instead of following that industry standard, we looked and say, "Well, what can I take with the training I have, with a license I have, with my skillset, and how can I niche what I do down to people I want to do business with, people who ideally can pay me for my services, and I'm not trying to open up the door to all comers? In other words, I don't want to be all things to all people. I don't want to hang a shingle out and say, 'I'm this business and I try to serve everybody.'" Because when you try to serve everybody, you oftentimes really don't serve anybody very well. And again, that negative energy tends to flow. The negative energy that drains you, drains your staff, commoditizes your business or your practice, and means that your results that you're going to get in life financially, but also just personal satisfaction become very, very average, very diluted in many cases, and that's what leads to burnout.

So again, my point in this lesson, I could go down many rabbit holes from this weekend on this particular business model. But the big one is to really determine where do you want to serve and who you want to serve in life, and don't try to be all things to all people. Niche it down, be focused, have clarity. The clarity won't come all at once. But if you spend your time and put yourself in environments where you yourself are challenged about your thinking, not to say that you're not a good thinker, but we all need outside perspective. We need people who can see things that we can't see. It's what I call blind spots. If you put yourself in environments where other people can weigh in on the questions, the challenges, and maybe the opportunities that you have in life, that's where you get clarity.

And that's what we were doing this weekend. We were doing that for each other, but also learning a business model where we could participate in certain real estate investments that have great downside risk protection.

Lots to unfold there. I'll do more on future episodes, but I want to keep this one relatively tight, to the point. The lessons here, niche, stay focused, clarity, remove, reduce negative energy, reduce that drag and friction, and your life will be much, much wider with much greater impact. You will experience more joy in life, which is what really the key is in everything we do. That's it for this week. Remember, always stay focused on your freedom, and I'll see you next time.

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