May 2021 Update With Justin Ford

Bob Irish
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As one of our privileged members, you get access to real estate expert Justin Ford's monthly DealBook updates.

DealBook covers special situations with our network of experts in the kinds of private deals most people never even hear about.

Each month, I check in with Justin to see how his previous real estate deals are performing. Justin also discusses the latest trends in the market, what to look for when purchasing property as an investment, and much more.

You can listen to my monthly interview with Justin or read the transcript below.

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Transcript

Bob Irish: Welcome to our monthly call with Justin Ford of Pax Properties. Justin is our resident real estate expert. Bob Irish here, your *Infinity* liaison. If you've been with us for a while, you know that Justin has been an extraordinarily successful real estate investor.

Throughout real estate booms and busts, Pax Properties has never failed to produce a positive result for investors and has never missed a mortgage payment. With that said, Justin, it's great to have you back. How are you doing?

Justin Ford: I'm doing well, Bob. Thank you very much. It's great to be speaking with you again.

Bob: So how are things going at Pax Properties? And hey, before we go there, what exactly is Pax Properties? I know it's spelled P-A-X, but can you go a little deeper?

Justin: So it's Pax, like you said. Sometimes people think it's Packs Properties or Tax Properties, which is the opposite. But Pax is just the Latin word for peace, and it's a good quality for a business to have.

It's also the way we approach things, our business, looking at the world, investment, all those kinds of things. We're really focused on peace of mind. We go for those things that we can control, not hanging your hat on what we can't control.

So we think a good way to look at the world as an investor is by focusing on things like cash flow, amortization, and positive leverage; how well you execute and how you plan in the long term. So that's what we're about, Bob.

Bob: Well, it sounds like a perfect name for Pax Properties. That makes perfect sense. So, Justin, how's the last month gone? Let's get some updates on the properties we've talked about in prior calls. Why don't we start with Melbourne?

Justin: Melbourne did well throughout the entire pandemic. It posted a positive EBITDA (earnings before interest, taxes, deductions, and amortization) every single month. In fact, I think it covered its debt service every month as well.

When the pandemic hit, of course, with all the hotels and business dropped we suspended industrial payments. We continued to make all our obligatory payments, private debt payments, and bank payments. Never missed a single one of those. But the equity payments we held off on, and we only did it for three quarters with Melbourne.

In, I think, January of this year, we started to resume payments, equivalent to 8.5% cash yield. And then just a few weeks ago, we made a payment for the first quarter and that was put into a 10% cash yield.

So Melbourne has really come out of the gate strong now that the economy seems to be opening up again. Additionally, we were on the verge of a significant refi [refinance] that would have returned a good chunk of initial investor equity capital when COVID hit.

So that market kind of froze up and now we're seeing new opportunities slowly beginning to emerge.

Yesterday, I was at a half-day seminar with my son, Chris. He works with me closely in a bunch of things. It was on SBA [small business administration] financing. SBA has different programs for hotels. They're not appropriate for the apartment buildings or shopping centers we have. But for hotels, SBA can really work. So we're looking at that as well.

Again, as we come out of this super depressed hotel market that we were in in 2020, we're starting to see a lot of opportunities opening up. We expect to continue to pay double-digit cash on cash yields or very close to that. And we think within the next 9 to 12 months, we'll have a significant refi, where we'll return a big chunk of investor capital as well.

Bob: Well, I think things are just going beautifully in Melbourne. That's a great report. Let's go up a little further north to Tallahassee and talk a little bit about the Baymont.

Justin: So the Baymont was our one hotel that was struggling the most during the pandemic. And it's odd because it's our only branded hotel. Of the seven hotels we had going into the pandemic, six were independent and Baymont was our only flag hotel, a franchise hotel.

We sold two of those small ones just before the pandemic hit for really significant profits, and that was after many years of good cash flow. The Baymont right now is starting to revive. That particular sector of the market was hit fairly hard, but we like our prospects going forward for the Baymont because Apalachee Parkway is a good street. We're right down from the capital.

Again, we practically have almost zero deferred maintenance issues of any type. We renovated the hotel a few years ago, we have all new furniture in there that's less than a year old, we put on all new locks recently, and the grounds look great.

So we had a conversation with Wyndham, which is the parent franchise, and we said, "We do better with our independents. We think we bring more value." All due respect to Wyndham, I'm not trying to knock them, but I said, "We think in this category, we bring more value to the hotel franchise than the franchise really brings to us because we believe that our property is so much higher than most Baymonts you'll ever find in the system."

So long story short, we were going to let the Baymont expire and go independent on that come this August. And franchises, hotels of all stripes – we've been talking to the Best Western – they've been approaching us. The Baymont offered us a nice deal. They said, "Hey, give us one more year. You don't have to sign up for another five years. Give us one year, we'll give you super discounts."

And, as you can imagine, they're highly motivated right now, as a franchisor, to work with their franchisees. So we have a very discounted deal for the next year. We have very clear performance criteria that they have to help us hit in areas like revenue management, which is how you adjust your rates or group sales or things like that.

So, the next year is going to be very interesting. Again, we're on a positive trend right now, but if we don't really knock it out of the park in the next year with Baymont, we're going to transition to being independent within a year. And judging by our other independent hotels, we would expect success with this one as well.

Bob: Okay. Let's go across the street to Governor's Square or the Renaissance. Tell me what's going on there. I think the last time we spoke, there was a potential refi in the works. Is that still happening or what's going on there, Justin?

Justin: Yeah. That's been a bit of the cha-cha. Three steps forward, three steps back. But we have found what we think is an excellent solution. A guy who did two small hotel loans for us eight years ago and I were talking, and he's now part of this very large group called Greystone. Greystone is one of the largest issuers of agency debt in the country.

We sat down, and we had a long talk. And long story short, we are now probably 35 days away from doing what's called a bridge loan, which is 65% loan to value.

We think it's going to get us close to about $13 million. We're going to pay off all the private debt, return about $1.8 million Pax had in there at zero interest, and return perhaps a little investor debt initially. We're also going to get all caught up in all deferred pref, which amounts to over 8.5% a year. We'll get all that done, but we're doing this at the same time that we're applying for the best agency loan out there right now.

So right now, Fannie and Freddie are at around 3.5%, 30 years, which is a very low cost of money, but we're going for a HUD [Department of Housing and Urban Development].

A HUD loan takes about six months to close, so we're going to use the bridge now. And then the goal is to close on the HUD loan in November. That would put our LTV (loan to value) up from 65% to 80%.

So now instead of 13, we're going to transfer it to 16 million, which lets us now return more capital to investors. Most of their initial capital, besides being caught up in the pref. And now our total cost of capital goes way, way down because the cost of this HUD loan is about 2.7% for 35 years. It's crazy. It's crazy to lock in that sort of low-rate debt.

Bob: Wow.

Justin: Yeah. So the long and the short is, we're on track right now to do about $1.4 billion in net operating income this year. When we put the kind of debt on it that I'm talking about, we'll have about an $18 million loan.

Let's even call it 3%, 35 years. The cash on cash that we'll be repaying, whatever the remaining investor capital is, may be 30% to 40% of the initial investment. I'm even hesitant to say that, because it sounds too good to be true, but you've experienced it before, Bob, because you've been along for a lot of our deals over a long time.

The cash on cash, when you return the first part of your capital, goes up to the double digits, and it can even be in the teens. It can even be in the low 20% range.

It's not magic. It's basically the way it works when you bring down your cost of capital so dramatically low, and you return a big chunk of cash to your investors, in addition to having paid them money on their cash.

Now, their amount of equity that remains is relatively small in proportion to the rest of the capital so that the cash flow that is produced is a very significant percentage on the cash remaining invested. So you get really great returns going forward. I hope I didn't make that too complicated, but long story short, we have the refi in the works, two-step refi.

Bob: Two-step refi. Well, that's great. I guess next month we'll have more of an update on how that's gone, but that's exciting news. Let's talk a little bit about Seven Hills and then we can head over to Ocala.

Justin: Okay so Seven Hills, for those who are on the call who don't know, is our newest hotel.

It was the second lowest rated hotel in the city of Tallahassee when we bought it. It was sort of a rundown mom and pop hotel, but it was on a beautiful piece of land with a handful of beautiful, sloping acres. We fixed it up. We made it beautiful, and after our grand opening in December of 2019, we hit No. 1 in the market on TripAdvisor within a few months.

We were on TripAdvisor's top award, the mayor of Tallahassee came by and praised us, this kind of stuff. And so we were heading for the big time with that one. We had $170,000 worth of bookings just for two nights during graduation alone. We were doing great.

Then all of a sudden COVID hit, and boom. In Tallahassee, state government, and schools give hotels a real durability in the long run. But this particular pandemic was especially hard for Tallahassee because the government stopped showing up in session. And the students didn't really go to school for the most part, so that was a hard-hit market. But we pivoted really quickly, and we actually ended up leasing out three quarters of our property to a local charity organization.

And that was great because every month throughout COVID, we ended up remaining profitable, paying our mortgage and all our debt without a problem. So that was a great, great pivot, but we were still a very new hotel, just as COVID hit.

About a month ago, we said goodbye to that charitable organization, and that was after a year. So now we're in the process of spending about a quarter million dollars – the organization will pick up a little more than half of that.

We're picking up the rest, which is fine. We plan to refurbish all those rooms that the charitable wards were in. And now we're operating fully as the market rate hotel that we expect it to be. Our average rate is the highest it is of all our hotels.

We pride ourselves on having very affordable hotels. One of the things we talk about is delivering extraordinary stays to people of ordinary means. So this is truly a beautiful hotel and it's really unique in the way it's designed, the concepts we executed, etc. For this hotel, the average retail rate is only around $129, maybe $119 per night. And so now we are operating, for the first time, as a fully market rate hotel. We're finishing renovating 120 of the 160 rooms.

We're taking a step back from all that guaranteed income. We're taking a step back, which is just a reduction of revenues we would expect while we're renovating and marketing again, and while the market comes back.

But I'm very confident that that hotel, within the next 18 months, will reach – or come very close to reaching – our original budget projections, which is about $3.6 million in revenue a year, and around a little more than $1.5 million in NOI (Net Operating Income). And that's with about $10 million invested and we think it will grow from there. So that's where we are right now with the Seven Hills Suites in Tallahassee.

Bob: Okay. Let's talk about the Horse Capital of the World – Ocala. [Horse Capital] is maybe an exaggeration. But what's going on with Equus?

Justin: Well, they wouldn't say it's an exaggeration. And now that I own a hotel there, I wouldn't say it either.

On June 17, if you're free, come to the Equus Inn at 3434 Southwest College Road, Ocala, because we're having our grand opening.

We completed all the interior rooms a little over a month ago, everything is done. One last piece we're doing is removing a pool pump to create this pergola and fire pit right by the pool. And that's being finished this week or next.

It's a truly beautiful hotel. Even while we're under construction, it went all the way up to No. 4 on TripAdvisor in the market. I'm fairly confident, it will be our third recent hotel to hit No. 1 in this market on TripAdvisor. I think it'll be our third hotel to win TripAdvisor's top award every year since it's been in existence. We have two like that now. This will be the third I believe.

And we're already seeing our rapport starting to grow. We've created quite a buzz in the community. We have a very good sales manager there. She knows everybody. She's very enthusiastic. She's always out at the functions.

We think we're on our track now, as we emerge from COVID-19. Ocala is a tremendous growth market. I used to go there, and it seemed like nothing was going on in the middle of Florida. Now, sometimes I'm waiting 15 minutes to try to make a left turn in front of our hotel.

And that hotel, I believe within 18 months should be high $2.9–3 million in revenue… And with an EBITDA close to 1.2–1.3.

So we're on track. We're just coming out of the gate right now, as the pandemic recedes and as we finish the final touches on construction. But so far, so good. We're growing consistently week after week.

Bob: Well, that's great news. I guess all in all, Pax Properties is emerging from this pandemic intact and in real good shape, generally speaking.

Justin: Yes. I'm very happy to say that. We did everything we could.

When the pandemic hit, not only did we rent our new hotel out to the charitable organization, we experimented with doing things like apartment-type rentals. We aggressively pursued construction companies for their business since they were one of the few businesses operating in the toughest days of the pandemic.

So we pivoted. We cut manager salaries 25%. Unfortunately, we had to let go of more than half of our staff. Pax Properties – myself – we didn't take management fees on anything for almost a year.

We did whatever was necessary to get through. We applied for all the PPP (paycheck protection program) and idle loans. We got them. We qualified for forgiveness of the PPP loans.

And today, as business is growing, our staff is almost back to where it was, as our business is growing to where it was.

So it's one of the things we do. Our approach to investing isn't trying to be clever or smarter than the next guy. We try to be clear-headed, clear-thinking, but we know for us, it all comes down to starting with a reasonable proposition: This makes sense… This vision, this idea is worthwhile… Now let's execute.

And when you execute, there are many phases of that. One of them is to acquire well, and then another one is to renovate well. And then once you have all that, you've got to staff it well, bring on good people who think like you do, who want to create something *really* worthwhile.

Then you've got to execute day after day. That's our business. We're not point-and-click investors. We're brick and mortar. We're pillowcases and bedspreads. We're a real business and we like our chances going forward.

Bob: Well, separately, I was having breakfast not too long ago with some folks who were very active in the residential real estate market. They were commenting about how hot the residential real estate market is right now in various areas around the country.

And I'm curious, what is Pax Properties seeing in the commercial real estate market?

Justin: It's very similar.

We look at markets all over, certainly through the Sunbelt. Everyone knows Florida's a hot market. All the properties you and I just talked about are updated and the other properties Pax has are in Florida.

But we work in Texas, Oklahoma, and Georgia. We're looking at a lot of different places. And everyone knows Texas is a growth state.

There are three main things that are driving the market, including the smaller residential market and even the commercial market.

There are three major macro forces I think at this moment are really creating and pushing prices.

One of them is this huge migration from cold states to warm. This is something that's been going on for a while, but this has been dramatically accelerated by the pandemic. It's from crowded to less crowded, from expensive to more affordable, from high tax and regulations to low tax and regulations. And this has been just multiplied by a significant factor increase over the past year. So that's driving a lot of it.

At the same time, where we operate at Pax Properties, we really like the bread-and-butter sector. We like to deliver extraordinary value to people with ordinary means, and that includes the apartment space.

There's a real under supply in many markets throughout the country of quality rental housing – especially in the working class and middle-class tiers – and that's where we really have always focused our attention.

And then the third thing is these historically low interest rates. I just talked about how we're going to shoot to lock in HUD financing on our 168-unit property in Tallahassee for 35 years – probably at under 3% by the time we close. Converging, these things have created a lot of pressure.

Yet, here's the interesting thing. You look around and you see prices rise, basically like we saw in '08 and '07 actually. You're seeing prices accelerate, and it's almost a little scary.

It's a little different now. It may not be different for long. It's different now because there's still a significant spread between the un-leveraged cash yields produced by apartments and so forth, and what you can get on incomparable seven-year or ten-year riskless money – or relatively risk-free money – as measured by the treasuries. There's still a spread.

Back in the [real estate] bubble days, apartments might have been selling for what's called a 4% unlevered yield – let's call it a 4% cap rate. But meanwhile, the seven-year and even five-year treasury was at 4%. So why would you even risk your money when you can do it "risk-free"?

Today, there's still a positive spread. We'll see how long that lasts. It may not last forever. But here's the sweet spot when you're talking about approaches to the market conditions today: If you really understand how to focus on the things we talk about – cash flow, amortization, positive leverage, diligent execution, an eye for the long-term – there are opportunities that are pretty amazing in some of these stealth growth markets.

What I mean by stealth growth market is this: The more key growth market of Florida or Texas – everyone knows people are pouring in there. And again, we're very active there. But there are markets like Tulsa, Oklahoma. Tulsa has grown more than the national average in jobs and employment for around the last 10, 20, and 30 years. But people don't think of it as a growth market. And it's a *very* cool place. There's a very interesting, dynamic long history. It's got a cool art scene. It's got an amazing food scene. And it's this steadily growing market that also offers tremendous value.

There are properties – using the types of approaches I'm talking about – after you spend $10,000 a unit on renovations, you could have a property that you own and operate for less than $75 a square foot. That's way below replacement costs. They could give you the land for free and you couldn't build for that cost. And your price is relative to your rents, so very generous. The prices relative to your rents are very reasonable.

So when you put your financing on it, after two or three years, you end up with high single-digit cash on cash yields – perhaps even low double-digit cash on cash yields. And that's in addition to the equity created by the principal reduction every year… So steady, low- to mid-teen equity and growth build up, without counting appreciation. Because I *never* count on appreciation. We've had that discussion before, but now temptation is a fickle mistress. Haven't we had that talk?

Bob: Yes, we have. Appreciation is not one of the things you can control.

Justin: That's correct. It's not one of the things you can control, and have we benefited from it? Certainly, we have, but we don't hang our hat on it. Because it's beyond our control. It doesn't matter if you have a PhD.

And by focusing on the things you can control, identifying some of these stealth growth markets, and focusing on this long-term approach, you can still find great value. It's not easy, but if you have the right discipline and approach, they're still out there.

Bob: Well, Justin you've summarized the commercial real estate market very succinctly. I'd like to go a little bit more in depth with you on our next call. Maybe then we'll have some specific markets we can get into a little bit more.

But in the meantime, thanks so much for the update. Anything to add before we sign off?

Justin: No. We're very happy at Pax Properties to have had this opportunity to talk to you these last few years. It's been a real pleasure and I look forward to talking to you next month.

Bob: Sounds great, Justin. Talk to you then.

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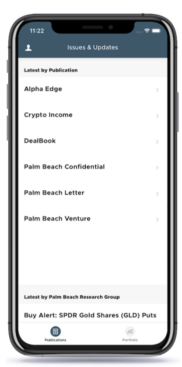

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