



## What to look for in a Private Placement Memorandum (PPM)

Because of the increasing demand for syndicated tenant in common (TIC) interests, many investors are reviewing a Private Placement Memorandum (PPM), a document that is strange and unusual to most real estate investors.

What is a PPM?

A PPM is the document that should disclose everything the investor of a new offering will need to know in order to make an informed investment decision. This includes: the offering structure, the structure of the company, SEC disclosures about the interests being purchased, company information, information on company operations, risks involved with the investment, management information, use of proceeds, information on certain transactions that could affect the investor, and investor suitability data. The PPM also includes the subscription agreement, which is the actual "sales contract" for the offering. This is the document that the investor will sign and send in with their investment funds. The PPM is prepared by the insurer (Sponsor) of the offering.

The PPM is an important document because it provides the investor with all of the information and disclosures that they will need to make an investment decision, including the actual documentation to effect the investment transaction. PPM's are designed as a stand-alone document - meaning that there need not be other information presented to the investor for them to make an accurate investment decision. Many companies will attach their business plans to the PPM as supporting documentation. This is acceptable so long as the information in the business plan properly conforms to the information in the PPM and that the investor is made aware that the business plan alone does not constitute an offer to sell securities - only the PPM can make that offer.

OK, why are they used in a TIC offering?

While properly structured TIC offerings are considered to be real property (not a security) by the IRS, there is a general consensus that for distribution and sales purposes, the SEC considers them to be a security (an almost perfect example of a homonym; two words that sound the same and spelled the same, but with different meanings). The general definition of a security is: A group of individuals, joining together for a common business purpose, with an anticipation of profit, using the entrepreneurial efforts of another. The vast majority of TIC offerings are considered a security for sales purposes.

Very simply, it is against the law to sell securities unless you are licensed to do so or can qualify for an exemption from the SEC rules. Section 5 of the 1933 Act clearly states that "it is unlawful for any person, directly or indirectly to sell a security unless a registration statement has been filed, or to sell a security or deliver a security after the sale unless a registration statement is in effect." The 1933 Act does, however, contain some exemptions, but they fall short of really helping small businesses, such as TIC sponsors.

These restrictions prompted Regulation D, better known as Reg D, which became effective April 15, 1982. Reg D is not just another exemption but one of the key exemptions for sponsors that wish to raise money by selling equity. Thus, the Reg D private placement document, better known as the Private Placement Memorandum, has been considered to be one of the most workable exemptions for small offerings, such as TIC offerings.

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Thus, by using a PPM pursuant to a Reg D offering, TIC sponsors can meet the requirements of the Securities Act in a manageable fashion, while providing potential investors with the disclosures and protections required by the Act.

OK, so what should I look for?

As stated above, the PPM is intended to provide all of the information necessary for an investor to make an informed decision about a prospective investment. At a minimum, a PPM should contain the following:

- i. The cover page and securities legends;
- ii. Suitability standards for investors;
- iii. Summary of the offering & use of proceeds;
- iv. Risk factors;
- v. Capitalization of the company or venture;
- vi. Use of proceeds from the offering;
- vii. Plan of distribution of the securities;
- viii. The business of the company or venture;
- ix. Selected financial data;
- x. Management & compensation;
- xi. Conflicts of interest by management;
- xii. Terms of the securities offered;
- xiii. Tax matters;
- xiv. Legal matters;
- xv. Documents available for inspection;
- xvi. Financial statements;
- xvii. Financial projections;
- xviii. Exhibits.

By nature these documents are long and detailed. As a result, many investors would prefer to look at just an executive summary, or at marketing material with pretty pictures and vague statements about how well the investment will do. This would be a very big mistake. The PPM is the Sponsor's chance to disclose all of the risks and conflicts associated with their offering. It is also the investors chance to objectively review these risks and conflicts.

The goal is not necessarily to find an offering without risk and conflict (we think that is an impossible quest). Rather, an investor (and their advisors) should carefully review each of the sections in a PPM to make sure that the prospective investment meets their investment criteria and provides the proper balance of risk and reward for their objectives.

Now, let's take a look at what should – and should not be included in a PPM.

Let's start by remembering that a PPM is not a marketing document. Instead, it is a document that should allow an investor to determine all of the risks and conflicts of a prospective investment – while also discussing the various opportunities and potential rewards of the investment. In other word, it should be a stand-alone document that allows an investor to make an informed decision about the potential investment.

First, every PPM must contain the following statement on the outside cover page in capital letters:

**THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION NOR HAS THE COMMISSION PASSED UPON THE**

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ACCURACY OR ADEQUACY OF THIS PROSPECTUS. ANY REPRESENTATION TO THE CONTRARY IS A CRIMINAL OFFENSE.

This means just what it says. The SEC never passes judgment on the accuracy of information, or the suitability of an investment. Any implication that a security has been blessed (in any way) by the SEC is illegal. In other words, read the document, ask your questions and keep your eyes open. Do not be lulled into false comfort just because the PPM is a big, authoritative-looking document.

Now, let's walk through the major sections of a PPM

1. **COVER PAGE:** The cover page should set forth, in addition to basic information about the offering, the termination date of the offering, any minimum required purchase and any arrangements to place the funds received in an escrow trust or similar arrangement.

The cover page should contain a tabular presentation of the total maximum and minimum interest to be offered.

The cover page also should contain brief identification of the material risks involved in the purchase of the securities with cross-reference to further discussion in the prospectus. The most significant risk factors should be identified where applicable.

2. **SUITABILITY STANDARDS:** These are the standards, if any, to be utilized by the Sponsor in determining the acceptance of subscription agreements should be described immediately following the cover page. Suitability standards should include those established by the registrant, if any, or by any self-regulatory organization or state agency having jurisdiction over the offering of the securities.

Most current TIC offerings are made available only to 'Accredited Investors', as defined under Rule 501 of Regulation D of the Securities Act, as amended. Generally speaking, this definition requires that an investor be (1) a natural person, with (2) individual income in excess of \$200,000 in each of the two most recent years, or joint income with that person's spouse in excess of \$300,000 in each of the two most recent years, and has a reasonable expectation of reaching the same income level in the current year; and/or the investor is a natural person whose individual net worth, or joint net worth with that person's spouse, exceeds \$1,000,000 at the time of purchase of the interests.

In addition to meeting the 'Accredited Investor' test, an investor must represent that they have read and fully understands the PPM any addenda, exhibits and attachments thereto. They must also show that they have the ability and willingness to accept and bear the financial risks of the offering, including the lack of liquidity and risk of loss of their investment.

3. **SUMMARY OF THE OFFERING AND USE OF PROCEEDS:** A two-part, concise outline summary relating to the offering and a tabular summary of use of proceeds should follow the Suitability section of the PPM:

- A. **Summary of the Offering.** The following information should be disclosed in outline form with appropriate cross-references, where applicable:
  - i. The name, address and telephone number of the Sponsor and names of persons making investment decisions for the Sponsor;
  - ii. The intended termination date of the offering;
  - iii. A statement, if true, that the Sponsor and its affiliates will receive substantial fees and profits in connection with the offering;

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- iv. If current distributions are an investment objective, the estimated maximum time from the closing date that the investor might have to wait to receive such distributions;
- v. Describe briefly the properties to be purchased. If a material portion of the minimum net proceeds of the offering (allowing for reserves) is not committed to specific properties, so indicate;
- vi. Describe the depreciation method to be used;  
State the maximum leverage expected to be used by the offering as a whole and on individual properties, where it may differ;
- vii. Include a cross-reference to the Glossary.

- B. Use of Proceeds. The use of proceeds tabular summary will vary according to the offering but should include, where appropriate, estimates of the public offering expenses (both organizational and sales), the amount available for investment, non-recurring initial investment fees, prepaid items and financing fees, cash down payments, reserves, and acquisition fees including those paid by the seller. Estimated amounts to be paid to the Sponsor and its affiliates should be identified. The summary should include both dollar amounts and percentages of the maximum and minimum proceeds of the offering. Inclusion of percentages of the estimated maximum and minimum total assets is optional.

### 4. COMPENSATION AND FEES TO THE SPONSOR AND AFFILIATES:

This section should include a summary presentation, itemizing by category and specifying dollar amounts where possible, of all compensation, fees, profits, and other benefits (including reimbursement of out-of-pocket expenses), which the Sponsor and its affiliates may earn or receive in connection with the offering or operation of the offering.

The type and method of calculation of compensation, fees, profits or other benefits that should be disclosed includes, but is not limited to, the following: disbursements incident to the purchase and sale of the TIC interests, including sales commissions, reimbursements for expenses, and real estate commissions; finder's fees; fees for property acquisitions, marketing or leasing up of properties, financing or refinancing, management of properties, insurance and miscellaneous services; commissions and other fees to be paid upon sale of the properties.

5. RISK FACTORS: This section should include a series of short, concise, paragraphs, with cross-reference to fuller discussions where appropriate, summarizing the principal risk factors applicable to the offering and to the Sponsor's plan of operation.

Risk factors to be discussed include:

- A. Tax Risk; A summary identifying the various tax risks of the offering and the general method of mitigation of this risk;
- B. Real Estate Risks; A summary of the risks related to the ownership and operation of real estate, including the risk of owning real estate as tenants in common, the risk related to any financing of the property, the risk of uninsured or underinsured losses;
- C. Risks relating to management of the property by the Sponsor;
- D. Risk relating to the offering.

Each of the risk factors summarized in this section should reference full discussion of the risk factor in the relevant section of the PPM.

### 6. CAPITALIZATION OF THE VENTURE, USE OF PROCEEDS, PLAN OF DISTRIBUTION:

This section will summarize the total capitalization and uses of proceeds of the offering, the qualification

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of investors, the sale of interests, the marketing of interests, the limitation of the offering, and the continued ownership (if any) of interests by the Sponsor.

7. **THE BUSINESS OF THE COMPANY OR VENTURE:** This is the heart of the investment – The property itself. Regardless of any other aspects or characteristics of an offering, at the end of the day, the offering is about a real estate investment and a prospective investor should very carefully review this section and should ask any questions that arise as a result of their review. If a prospective investor does not receive satisfactory answers to their questions about the property, they should not invest in that offering.

This section will include:

- A. Description of the Property, including its location, age, construction methods, occupancy;
- B. Summary of leases;
- C. Description of key tenants;
- D. State, city and neighborhood overview;
- E. Market overview;
  - i. Economic conditions;
  - ii. Vacancy & absorption;
  - iii. Rental rates;
  - iv. Construction activity;
  - v. Competition;
  - vi. Sales Comparables;
  - vii. Conclusion.
- F. Acquisition terms and financing
  - i. Purchase of the property;
  - ii. The loan;
  - iii. Closing costs;
  - iv. Acquisition fee;
  - v. Real Estate Commissions.

8. **MANAGEMENT, CONFLICTS & COMPENSATION:** If the business of the venture is the heart of the offering, this is the brain. After all, the manager will operate the property for the benefit of the investors. If an investor is not satisfied that the manager is able to do so in a competent and professional manner, they should not invest in that offering.

This section consists of two portions:

- A. Management of the venture. This portion will include, in summary form, a biography of the key officers/employees of the Sponsor, the experience of the manager, the fiduciary duties of the manager, and conflicts of interest (actual or potential) concerning the manager.
- B. Compensation. This portion will detail all of the various forms of compensation to the Sponsor, categorized by their inclusion in the (1) offering and Organization Stage, (2) Operating Stage and/or (3) Liquidation Stage. Any compensation to the manager must be disclosed in this section, including:
  - i. Acquisition fees and/or real estate commissions;
  - ii. Reimbursement to Sponsor of organizational, offering and marketing expenses;
  - iii. Management set-up fees;
  - iv. Property management fees;
  - v. Reimbursements of expenses to manager;
  - vi. Leasing commissions;

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- vii. Construction management fees;
- viii. Disposition fees or real estate commissions;
- ix. Any other forms of compensation to the Sponsor and/or manager.

9. **TERMS OF SECURITIES OFFERED.** This section will discuss the rights, obligations and limitations imposed upon any purchaser of the interests offered in the PPM. Specific aspect covered will include:

- A. Restriction on transferability;
- B. Purchase options (by either the Sponsor or other TIC interest holders);
- C. Summary of the LLC agreement (if any) and related income & loss distributions;
- D. Summary of tenant in common agreement (including);
  - i. General provisions;
  - ii. Term;
  - iii. Appointment of property manager;
  - iv. Cash contributions;
  - v. Voting;
  - vi. Transfer rights;
  - vii. Income, expense and cash flow distributions;
  - viii. Property rights;
  - ix. Bankruptcy;
  - x. Tax Elections.
- E. Summary of the management agreement
  - i. General provisions;
  - ii. Term;
  - iii. Rights & duties of manager;
  - iv. Budget;
  - v. Leasing;
  - vi. Compensation;
  - vii. Right (if any) to subcontract property management functions;
  - viii. Sale of the property;
  - ix. Expenses;
  - x. Indemnification of property manager.

8. **TAX & LEGAL MATTERS.** This section will discuss the Federal income tax consequences of investing in the interests offered in the PPM, together with any anticipated legal matters related to the investment. Generally, TIC offerings provide for investment either as a member in a limited liability company (LLC) or as a direct owner of a TIC interest. The tax matters section of the PPM (and/or the TIC addenda) will discuss the various tax consequences of investing in either form. Legal matters will include a discussion of the investment in the offering by qualified plans and individual retirement accounts, as well as a disclosure of any litigation pending against the manager, property manager, and/or Sponsor.

A section that is of great importance for TIC investors, is the tax opinion offered for the benefit of these investors. Most TIC investors are considering this form of investment in order to complete their 1031 tax-deferred exchange. If the investment does not carry a high likelihood of acceptance as 'Qualified Replacement Property', there may be little reason to invest in the offering.

However, while the tax opinion is very important to TIC investors, all investors should very carefully review the tax consequences of any investment before investing, or committing to invest in any offering.

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If an investor is not satisfied with the tax risks and consequences of an offering, they should not invest in that offering.

9. DOCUMENTS AVAILABLE FOR REVIEW, FINANCIAL STATEMENTS, AND FINANCIAL PROJECTIONS. Generally, a PPM will provide for review of underlying documents by potential investors. These documents often include:

- i. Appraisal;
- ii. Title report (including underlying documents);
- iii. Property condition assessment report;
- iv. Environmental report;
- v. Seismic report (if applicable);
- vi. Market reports;
- vii. Current rent roll;
- viii. Current budget.

In addition, the PPM will include cash flow projections (including a summary of the assumptions to those projections), a disposition analysis and an investor return analysis (including a summary of the assumptions to these analyses). Detailed versions of these projections and analyses are typically made available to prospective investors upon their request.

10. EXHIBITS. Typically, a PPM will include copies of the LLC agreement (if any), the TIC agreement, the management agreement and the subscription documents. These are the actual documents that will govern operation of the property and are therefore critical in the review of the investment.

No prospective investor should invest, or commit to invest in any offering where they have not first fully reviewed each of these documents. In addition, regardless of their desire to invest in the offering, no investor should ever invest in an offering if they are not willing and able to comply with the terms and conditions contained in these documents.

CONCLUSION. A PPM can be a daunting document for the average investor. However, if one breaks down the various sections, it can be a very useful guide to compare one investment against another. A property written PPM educates and protects the investor, discloses the risks and opportunities of the investment and protects the Sponsor from certain types of liability. Not bad for one little document.

**CapHarbor is a real estate brokerage company serving the needs of 1031 investors who are seeking passively managed replacement properties (Single-Tenant, NNN-Leased properties by the whole through our real estate licenses and tenant in Common (TIC) interests on a fractional basis for accredited investors through our securities licenses). Visit us at [www.capharbor.com](http://www.capharbor.com) or call 877-886-1031 to learn more about our services.**

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