

DST Offering Due Diligence



DAI Securities advocates for our advisors and the clients they serve. We strive to protect investors through an effective due diligence framework. Due diligence means conducting a reasonable investigation of the issuer and the offering. DAI utilizes both quantitative and qualitative analysis when conducting research on investment sponsors and their offerings. DAI's selective screening process allows us to provide a best-in-class investment platform, aimed at helping clients achieve their financial objectives.

Who Conducts Due Diligence

Sponsor and Lender

Sponsors conduct due diligence at the property level prior to acquisition. Lenders providing financing for the acquisition will also conduct due diligence on the property and borrower.



Managing Broker-Dealer

Before a property is syndicated as a DST offering, the managing broker-dealer conducts due diligence on the sponsor and offering to determine if all disclosures are current and adequate. Some MBDs are affiliated with the sponsor and reviews are not considered independent.



Third Party Due Diligence Firms

There are multiple third party firms that conduct independent reviews of sponsors and offerings. These reports are an essential part of the risk management process.



DAI Securities

FINRA requires broker-dealers to conduct an appropriate level of due diligence on investments offered by the firm. This piece provides an overview of DAI's due diligence process for DSTs.



Advisor

Under Reg BI, registered representatives must exercise reasonable diligence, care, and skill when making an investment recommendation.

DAI Sponsor Level Due Diligence

Before an offering can be considered for addition to DAI's platform, due diligence is conducted at the sponsor level. The sponsor is the organization that seeks out an investment opportunity, syndicates it to the market, and is responsible for overseeing all aspects of the investment. Sponsor reviews typically begin with having the manager complete a due diligence questionnaire and conducting research in the areas listed in the table below. An onsite visit or virtual interview with key principals from the manager is typically part of the process. To supplement our due diligence, we will also review an operational due diligence report prepared by a third party firm, if available.

Qualitative Review

- Firm history and reputation
- Ownership structure of the firm
- Background and experience of firm principals
- Management turnover
- Quality of service providers (auditor, legal counsel, etc.)
- Insurance coverage
- Key firm policies and procedures

Quantitative Review

- Sponsor financial statements
- Prior performance/ track record
- Investor communications for currently operating programs

DAI Offering Level Due Diligence

Once a manager has been vetted through sponsor level due diligence, offering level due diligence may be conducted. This process consists of reviewing offering information included in the due diligence kit, requesting additional materials, and communicating with the sponsor as needed. The primary items we review on each DST offering include:

- Private placement memorandum and any supplements
- Sponsor pro forma financial projections
- Property appraisal, property condition assessment, and environmental reports
- Property historical financials (if available)
- Due diligence reports conducted by an independent third party firm
- Online property search including location on Google Maps
- Tax Opinion

Key areas of focus in our analysis include fees, financing, sponsor assumptions in the pro forma forecast, and property/market information.

Key Areas of Focus



Fees

We look at fees as a percentage of equity and a percentage of total syndication and analyze whether these fees are in line with industry standards for similar offerings. Fees are viewed in three categories: real estate acquisition fees, sponsor compensation, and syndication expenses. We also consider the total offering expenses, or the load, that must be overcome through property appreciation and/or cap rate compression at exit.

Financing

If bridge financing is used to acquire the property, we consider terms and rights of the bridge lender to ensure the trust and investors are protected from recourse actions. Some sponsors utilize structures that require the bridge lender to be repaid within a specified time frame. If capital raise is slow, and the bridge lender cannot be repaid by the maturity date, the provider may have the ability to take over the DST and force a sale of the property. These structures increase the risk of loss and could result in adverse tax consequences for investors.

We also review the terms of any permanent financing placed on the property:

- Is the leverage used accretive to investor returns? Or is negative leverage impacting returns to investors?
- Floating rate debt exposes the trust and investors to interest rate risk. If floating rate debt is utilized, has the sponsor obtained a hedge to lock the rate and mitigate risk? The cost of hedging instruments are also considered in the fee analysis.
- Analyze forecasted debt service coverage ratios to ensure interest and principal payments can be met with income generated by the property.

Sponsor Assumptions and Pro Forma Forecast

When analyzing the sponsor's pro formas, we want to ensure the assumptions are reasonable. We will compare forecasts with historical financials to ensure growth assumptions are in-line with prior performance. Other factors to consider include, but are not limited to, planned value-add projects and the future outlook for the property's market in terms of new supply coming online. We also compare the sponsor's assumptions with the appraisal and third-party due diligence firm underwriting.

The use of financial engineering techniques to increase return projections is a strategy used by some sponsors in the industry. This is typically done to make the sponsor's deals appear more attractive than other offerings available in the market. While many may assume cash flow projections are based on property performance, unfortunately, that is not always the case. Some sponsors have turned to the utilization of reserves to support cash distributions. In this scenario, investors' loaded money is being returned disguised as cash flow to make the offering appear competitive and sell more interests.

Property and Market Information

The property's appraisal, property condition report, and environmental assessment are major resources utilized during our review process. Considerations include:

- How do the acquisition price and cap rate compare to those determined by the appraiser?
- Are reserves adequate for estimated repairs over hold term?
- Are the neighborhood demographics favorable to the property type?
- How does the property compare to other similar properties in the market?
- Is the transaction in line with recent sales comparables?
- Where do the current and projected rental rates of the property fall in relation to competitors?
- Are there additional properties proposed or under construction that are expected to compete with the property?
- Are there unique risks to property based on the asset class, location, etc.?
- Are there any environmental conditions at the property that may present additional risks?

Investment Committee

Once our investigation of the sponsor and program is complete, research is compiled into a comprehensive due diligence report and provided to the investment committee. The committee meets on a weekly basis to review offerings for approval. DAI's investment committee is comprised of five management-level individuals from the firm. Collectively, the members have over 100 years of experience in the financial services industry with depth of expertise in real estate and alternative investments.

Ongoing Due Diligence

Once a DST offering has been approved at DAI, ongoing performance of the program is monitored. We request sponsor and offering level information to be provided on a regular basis including:

- Sponsor financial statements
- Recent full-cycle events
- Updates on legal/regulatory issues relating to the sponsor, its affiliates, and investments
- Senior management turnover
- Offering level financial statements
- Current performance compared to original projections in the offering memorandum
- Material disclosures

In addition, third party due diligence firms are often engaged to provide ongoing sponsor level reviews on a regular basis. DAI utilizes these reports to supplement our own due diligence.

Advisor Due Diligence

The due diligence process does not end at the broker-dealer level. Registered representatives are required to conduct their own investigation of a product prior to making an investment recommendation. DAI provides resources and support to our associated representatives to facilitate their due diligence process. We host monthly webinars to keep our advisors informed on important due diligence related topics, including information on recently approved offerings. In addition, the advisor's due diligence process may entail:

- Review of offering materials and third party due diligence reports
- Completion of offering specific education modules (required by DAI)
- Conversations with members of DAI's due diligence team/ investment committee
- Interviews with sponsors
- Sponsor hosted due diligence meetings and/or property site visits

For more information on 1031 Exchanges or DSTs as replacement properties, please contact:



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Bill McNamara
Direct (888) 669-3332, Ext 1
wlm@snetinvest.com
www.fai1031.com

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